January, 23, 2012

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Delivered via email: comments@FDIC.gov

Re: **Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions [FDIC: RIN 3064-AD70]**

- **Comments by James H. Gellert, Chairman and CEO, Rapid Ratings International Inc.**

Dear Mr. Feldman:

Rapid Ratings is pleased to have the opportunity to comment on the your Notice of Proposed Rulemaking (NPR), amendment to market risk NPR published on January 11, 2011, Risk Based Capital Guidelines: Market Risks; Alternatives to Credit Ratings for Debt and Securitization Positions.

Background: Rapid Ratings International Inc. is an independent research and analytics company headquartered in New York since 2007. It provides its services to commercial users, asset managers and regulators, services that often involve the surveillance of loan and investment portfolios.

RRI assigns Financial Health Ratings (FHRs™) to more than 7,100 publicly reporting companies and thousands of private companies around the world; these are summary measurements of financial and operating efficiency, based entirely on balance sheet and income statement information, as often as that information is made available. Such measurements are applied according to 24 separate, proprietary industry models derived from the careful study of more than 300,000 companies of all sizes and descriptions over more than 30 years of operating history. Independent academic research, along with our own, concludes that our approach results in signals of deterioration that come years before those of the major rating agencies.[1]

[1] Jess Cornaggia, PhD, is an Assistant professor at Indiana University Bloomington - Kelley School of Business. Kimberly Rodgers Cornaggia, PhD, is an Associate Professor American University - Kogod School of Business. The authors' note reads: "To support our use of Rapid Ratings as an exemplar, we note its recognition by regulators,

Rapid Ratings takes fees only from end-user subscribers; we take no fees from any of the companies we rate, nor do we engage managements in any pre-rating discussions – in order to prevent conflicts of interest and to maintain our total objectivity.

Rapid Ratings is not a Nationally Recognized Statistical Rating Organization (NRSRO). We've elected to not apply for the designation. We see the designation as having diminishing value yet increasing and unknown costs.

Congressional Testimony: I have had the privilege of testifying in front of both Houses of Congress and the SEC about matters that relate directly to your issue at hand. Transcripts of my opening remarks and full testimonies to the House Financial Services Committee, Subcommittee on Oversight and Investigations, on February 2nd, 2012 *(The Collapse of MF Global)* and on July 27th, 2011 *(Oversight of the Credit Rating Agencies Post Dodd-Frank)* are included with this submission. (See attachments.)

Views on Amendment to Market Risk NPR of January 11, 2011: In the view of Rapid Ratings and its subscribers, any institution that puts itself at risk of corporate obligors and counterparties is best served by having a diversity of analytical resources at its disposal. There is no one system – internal or external – that can be presumed to be so comprehensive and so consistent as to detect each and every meaningful and unwelcome change in a corporation's financial condition or prospects. Our thinking in no way conflicts with the judgments of Congress and of federal regulators that call for an end to rigid and explicit reliance on the opinions of major credit rating agencies in federal and other codes and regulations.

In our view, the ratings that come from traditional rating agencies are necessarily made subjective by their incorporation of committee-based opinions on both the quality of a company's management and strategy and the suitability of its observed financial performance. Likewise, we also believe that scoring systems that rely on market signals such as share prices, volatilities and credit spreads can often be subjective and misleading in themselves, when they are considered in light of the multitudes of factors that routinely influence such signals. If the Dow Jones Industrial Index falls hard today on increased fears of a sovereign default in Europe, is Proctor & Gamble really more likely to default on its obligations? Rapid Ratings does not think so.

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law makers, and market participants. RR was the only non-Big-3 credit rating agency invited to speak on the ratings competition panel at the SEC Roundtable in 2009 and to testify before both congressional bodies in the run up to the most sweeping change in rating agency regulation in history." (Cornaggia J, and Cornaggia, K. *Does the Bond Market Want Informative Ratings?* 2 May 2011.
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1705843&download=yes)

Our interpretation of Dodd-Frank 939A is indeed that federal agencies must remove reference to or requirement of reliance on credit ratings. However, we understand that this is not to prohibit federal agencies from using credit rating agencies' data in the substitute, but that federal agencies cannot rely exclusively on credit rating agencies' data as the substitute. In other words, a multi-factor approach that includes ratings may be an acceptable alternative.

The Strength of Non-Discretionary Analysis: In our view, there is a very important place in the corporate risk measurement and management space – the space that both depositories and regulators occupy – for hard, timely and entirely non-discretionary calculations of operating and financial performance, calculations that use proven, empirically based metrics applied discretely to a range of individual industries, rather than metrics of varying origins that typically address only two simple industry models – financial and non-financial.

Rigorous, non-discretionary, empirically based calculations are both objective and replicable over lengthy time frames and varied geographies. Non-discretionary approaches also permit analysts to make reasonable estimates of the impairments that will come from large and unwelcome changes in the circumstances of obligors that are systematically important to lenders – either locally, regionally or nationally.

In the summer of 2010, several of our clients in the energy industry asked Rapid Ratings to take their cost estimates of the BP oil spill in the Gulf of Mexico and tell them what their estimates meant for BP's sustainability. We were able to reassure each of them that BP would remain a viable, if somewhat diminished, entity on the basis of their individual loss estimations.

Non-discretionary, empirically based approaches are also indefinitely scalable, in a way that would allow for the far greater and more timely regulatory surveillance of local, regional and national exposures among depositories, according to uniform metrics, and for the identification of trends among industries and the economy as a whole. In Rapid Ratings' case, for example, our continual analysis of the homebuilders sector, including companies with no debt outstanding and with no ratings elsewhere, demonstrated as early as the fall of 2006 that major deterioration was underway, deterioration whose further ramifications eventually became painfully clear.

Rapid Ratings already aggregates all of the quarterly reporting of approximately 5,000 public US industrial and financial companies into 31 monthly Sector Reports detailing real-time industry momentum.

Rapid Ratings respectfully suggests that regulators encourage financial institutions, and one another, to apply more, not less, due diligence in the pursuit and evaluation of sturdy third-party analytical and research reinforcement. Rapid Ratings is in no doubt as to the strength and singularity of its candidacy.

RapidRatings

The Future: We are in no doubt, either, of the gravity and the magnitude of the work that confronts the agencies in this exercise. I will be pleased to answer any questions that executives of the FDIC, the Board and the OCC have on this submission and/or any other topic on which the agencies believe Rapid Ratings may be of use, at your earliest convenience.

Sincerely,

James H. Gellert
Chairman and CEO
Rapid Ratings International Inc.
86 Chambers Street, 7th Floor
New York, NY 10007

Testimony Concerning:
"Oversight of the Credit Rating Agencies Post Dodd-Frank"

James H. Gellert
Chairman and CEO
Rapid Ratings International, Inc.

Before the
United States House of Representatives

Committee on Financial Services,
Subcommittee on Oversight and Investigations

July 27, 2011

On behalf of Rapid Ratings' employees and shareholders, I would like to thank Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee for asking me to submit testimony for the hearing titled *Oversight of the Credit Rating Agencies Post Dodd-Frank* before the United States House of Representatives' Committee on Financial Services, Subcommittee on Oversight and Investigations.

As we arrive at the one year anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) we continue to face essentially the same ratings landscape as one year ago. The Big Three ratings firms, S&P, Moody's and Fitch, have had banner years given record bond issuance for most of the year and their influence is undiminished, competitor NRSROs have even more challenges than ever before, and non-NRSRO rating agencies, like Rapid Ratings, watch the disincentives to an NRSRO application mount ever higher.

Dodd-Frank and the Securities and Exchange Commission's (SEC) implementing regulations, which are currently out for comment, are a combination of positive, negative and worrisome initiatives. Dodd-Frank does not do much to truly foster competition in the market, and depending on how the SEC decides to implement its new oversight responsibilities, may even directly hinder it. Moreover, we know Dodd-Frank adds significantly to costs for smaller NRSROs in terms of legal, administrative and compliance expenses, board compensation, insurance costs, and more.

Dodd-Frank has some positive elements for effective change in this industry, but it also gets bogged down in window dressing that ultimately does little except apply a disproportionate burden on the small NRSROs while providing little more than an administrative hassle to the Big Three. Dodd-Frank is right to reduce references to NRSROs in federal regulations. But, it is drifting down a slippery slope in increasing liability standards for CRAs. In an effort to determine accuracy in ratings and oversight of methodology, Dodd-Frank risks actually homogenizing ratings, increasing systemic risk and putting competitors' intellectual property at risk. In the following pages we detail many of the sections within Dodd-Frank and highlight what we consider good, bad and neutral in the new rules.

There is no silver bullet to change this industry. Use of NRSROs is too embedded in workflow practices of the investment community and in not just federal regulations but is prevalent in state regulations, private contracts, bank pricing grids, pension parameters, internal risk guidelines of institutional investors and on and on. But change can happen with effort. Like whale oil to petroleum, horses to cars, typewriters to computers and mail to email, innovation comes to markets that are not artificially protected and supported. New ideas, methodologies, ambitious teams of people, capital, hard work, and time, will ultimately prevail. It is incumbent upon legislators and regulators to help, not unintentionally hinder, this evolution.

Background

Rapid Ratings is a subscriber-paid firm. We utilize a proprietary, software-based system to rate the financial health of thousands of public and private companies and financial institutions quarterly. We use only financial statements, no market inputs, no analysts, and have no contact in the rating process with issuers, bankers or advisors. Our ratings have an impressive record for far outperforming the traditional issuer-paid rating agencies in innumerable cases and also generally outperforming the prevalent market-based default probability models.

We rate companies irrespective of whether they are bond issuers. We also do not distinguish between those companies that are issuing new securities versus those who have securities outstanding. Unlike the Big Three, we are focused on providing ratings that are updated quarterly and provide the highest accuracy, breadth of coverage and speed to market to reflect the changing financial health profile of firms we rate. The Big Three are naturally focused on primary issuance, where they traditionally get paid the majority of their fees, and risk surveillance of ratings already issued is a secondary focus. This is one of the great failings of the incumbent system and a perfect example of where a new player employing an innovative methodology can provide great value relative to the status quo.

Much has been made of the ratings industry problems: conflicts of interest, inaccurate ratings, lack of proper oversight, unchecked growth, fight for market share, overreliance on NRSRO ratings, lack of competition in the market to challenge the “Big Three” (S&P, Moody’s and Fitch), and the list goes on.

Dodd-Frank is supposed to curb conflicts of interest, reduce the risks inherent in the current ratings industry market structure, add transparency, force compliance, instill accountability, promote ratings accuracy, lower investor reliance, evolve the structured products ratings process and foster competition in the ratings industry.

US legislative and regulatory attention to the ratings industry is concentrated on the NRSRO designation and therefore the 10 players that currently carry that status. Since my business partners and I acquired Rapid Ratings and moved the business from Australia to the US in 2007, we’ve taken the view that having an NRSRO registration was undesirable given the dramatically changing environment for NRSROs. Little has changed my view over the past few years of SEC and Congressional activity. Why take a young, hungry competitor in the ratings space and subject it to all manner of change, increased scrutiny, costs, liabilities, uncertainties and a playing field that changes, then changes again, and so on?

My background, prior to the acquisition, was not in the ratings business. I was a debt capital markets officer for large banks, a technology entrepreneur and a boutique investment banker for small to mid-sized enterprises. I had extensive interactions with the rating agencies, particularly the big three NRSROs. I saw ratings shopping, I worked with bankers who had just arrived fresh from jobs at the Big Three agencies and were hired to advise bank clients on how to get the best ratings from their ex-colleagues, and in general the agencies were a central feature of any bond issue – structured bond or plain vanilla corporate issuance.

As a ratings entrepreneur however, I would like to think I did, and do, view the ratings business from a fresh perspective. The opportunities for a sophisticated and innovative competitor firm are significant; however, so are the obstacles. No business I have ever run, worked in or advised, has ever operated in such an idiosyncratic market -- historical regulatory support for incumbent players, a true oligopoly, massive criticism every few years followed by superficial *mea culpas*, well-meaning but often less than effective reforms, and tremendous lobbying by the incumbent players.

It is important to recognize that there are many market players who benefit from, and support, the status quo. After all, it is easy to rely on S&P and Moody's. It is cheaper to rely on S&P and Moody's than to staff an independent credit department. It is simpler to use the government sponsored imprimatur than to decide on what alternatives to use. It is advantageous for funds that are not allowed to buy below investment grade bonds to buy the highest yielding, lowest investment grade bonds because there is a regulatory arbitrage to do so.

Rapid Ratings' Evaluation of the NRSRO Opportunity

In prior testimonies such as to the Securities & Exchange Commission's "*Roundtable to Examine Oversight of Credit Rating Agencies*," to the U.S. Senate Committee on Banking, Housing, and Urban Affairs at a hearing titled *"Examining Proposals to Enhance the Regulation of Credit Rating Agencies,"* to the United States House of Representatives' Committee on Financial Services' Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises at a hearing titled "*Transforming Credit Rating Agencies,*" and to the International Organization of Securities Commissioners ("IOSCO") Standing Committee Six, Rapid Ratings has been clear that getting the NRSRO designation at present would be more a contingent liability than an asset.

Given this position, we observe all of the changes that come from Dodd-Frank from three perspectives: 1) What if we were an NRSRO now? 2) Do we want to consider applying to become an NRSRO now? and 3) What effects will Dodd-Frank have on us as a non-NRSRO if we remain as such?

While the answers are complex, they can be summarized:

1) If we were an NRSRO now we'd be subject to massive increases in our operating costs and significantly more complex internal processes. We'd be taking on increased liability. We'd be at the mercy of the SEC and its eventual rules for disclosure of methodology and procedures, ratings accuracy, and other transparency--oriented initiatives.

2) As far as we can tell, the ultimate landscape for operating as an NRSRO is still very much up in the air. We consider many of the SEC's proposed methods of discharging their responsibilities under Dodd-Frank to be threatening our critical Intellectual Property and revenue model. The uncertainty on these issues alone is a massive disincentive to file an NRSRO application.

3) Until the SEC finalizes its rules and policies for carrying out Dodd-Frank, we cannot really answer this question for ourselves. The increased liability notwithstanding, we can continue to do our business and grow successfully, but have no further incentive to pursue the NRSRO status than we have had in the past.

In order to understand the ratings market and to reform the industry, it is critical to appreciate the complexities that abound and how deeply ingrained the use of traditional ratings has become. To those less familiar with the industry, it seems like one that can be altered through seemingly simple solutions – change the payment structure to disallow issuers to pay for their ratings and force transparency on the raters. But the use of the Big Three's ratings goes much deeper than it appears, and the roots of their influence run wider than most understand.

Dodd-Frank and Reform in the Ratings Industry

Increasing reporting, increasing liability and even removing references to NRSROs are all elements, but not solutions unto themselves. More regulation and reporting requirements, and even increased liability, have the opposite of the intended effect; they help the incumbents as much as they hinder them.

Reform will ultimately only come when the following facets of change are promoted effectively:

- Increase the landscape for competition. Do not allow unintended barriers and compliance costs to stifle smaller players and newer revenue models;
- As mandated by Dodd-Frank, remove references to NRSROs from regulations in an effort to, over time, decrease dependence and irresponsible, risky reliance on the Big Three firms;
- Promote innovation in ratings and market stakeholders' use of myriad risk management inputs. Do not allow a homogenization of ratings;
- Increase the flow of data critical to providing new ratings into the market;
- Recognize that the status quo is supported on all fronts by some, though not all, players. This includes ratings firms, sell-side shops, regulatory and legislative infrastructure and members of the investment community;

- In the following sections, we've outlined Dodd-Frank developments that we believe are positive, negative and neutral at present. We also highlight a few areas uncovered by Dodd-Frank. Finally, we also include a suggestion for a simple, yet powerful addition to the SEC's oversight in the ratings industry:
    - **Positive Developments**
        - Removal of statutory references to ratings
        - Accountability and transparency of NRSROs —Look-back requirement
    - **Negative Developments**
        - Accountability and transparency of NRSROs —Methodologies reviewed
        - Accountability and transparency of NRSROs —Ratings performance
            - *Why are accurate ratings good?*
            - *What are the economic effects of the stability vs. accuracy debate?*
            - *Absolute vs. Relative Risk*
            - *How can ratings accuracy be bad?*
            - *Disclosure of ratings histories*
        - Accountability and transparency of NRSROs —Board composition
        - Eliminating the three-year requirement in NRSRO accreditation
        - Liability issues
    - **Neutral Developments**
        - Qualifications standards for NRSRO analysts
        - Separation of sales/marketing and ratings analysts
    - **Other Factors**
        - Access to data required for unsolicited ratings
        - Corporate counterparty risk
        - The Franken Amendment
        - Rapid Ratings Proposal for Increased Ratings Accuracy and Integrity

Positive Developments

SEC. 939. REMOVAL OF STATUTORY REFERENCES TO CREDIT RATINGS[1]

We believe that the removal of statutory (laws) and regulatory (administrative requirements) references is one of the key tenets to ultimate change in the ratings industry. References in federal statutes have been a major contributor to the market's reliance on the dominant NRSROs for decades. Combined with statutory and regulatory references, investment

[1] United States. Cong. House of Representatives. *Dodd-Frank Wall Street Reform and Consumer Protection Act.* 111th Cong., 2nd sess. H.R. 4173. Washington: GPO, 2010. Web. (508) http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf

managers have constructed policies to comply with the NRSRO standards, international standards such as Basel I, Basel II and Basel III international banking regulations have followed suit and thus the market has been able to rely on the constant presence of NRSRO ratings in myriad ways. In many respects, nothing has contributed as much to the market overreliance on NRSROs as these references and the explicit mandate that they be used.

We accept that removing references is easier than finding their replacements. Various federal agencies have been instructed by Dodd-Frank to make changes such as striking "'nationally recognized statistical rating organization' and inserting 'meets such standards of credit-worthiness as the Commission [Securities and Exchange Commission] shall adopt.[2]'" Nevertheless, a pure "replacement" may be impossible to find and we challenge the view that any single replacement would be appropriate given that the original option (NRSRO ratings) did not pan out particularly well as a standalone risk measurement.

As an example, Credit Default Swaps are often proposed as an appropriate proxy for risk. While CDS are likely the most sophisticated measure of the market-based options, they have significant limitations:

- **Narrow Range:** There are not CDS on enough issuers, thus giving only partial coverage of the investible universe, and there are few CDS on private companies;

- **Liquidity:** Some credit default swaps are traded in much larger volume and with much greater frequency than others;

- **Volatility:** CDS, as with all market measures, have inherent volatility. This means a regulatory framework where capital is benchmarked to CDS will fluctuate, potentially significantly. As with all market measures, CDS are subject to technical factors that have nothing to do with the credits themselves but will have to do with overall market liquidity, volatility, short-selling, etc. The swings that can occur due to these factors, particularly if they are market-wide, can skew the risk profile of a portfolio that will improve or deteriorate in a correlated fashion instead of on a credit by credit basis. Good credits will be unnecessarily penalized while poor credits may well be obscured or buffeted inappropriately.

  As cases in point, if risk was benchmarked to CDS, GE/GECC would have been rated CCC in March of 2009 and Italy, Spain and various global commercial banks would have been downgraded to junk in the weeks leading up to this hearing.

Rapid Ratings firmly believes that market-wide risk management should not be prescriptive but that players needing to manage risk must be encouraged to take diverse approaches. There is no single measure of risk that is appropriate for all market players at all times. Multiple factors

[2] (H.R. 4173, 511)

need to be taken into account and federal agencies need to be creative in replacing the NRSRO references. Most importantly, agencies need to avoid being reductionist and looking for an answer that is too simple.

Irrespective of the above and of the ultimate conclusion of each federal agency, removing NRSRO references is an essential place to start and is fundamental to sending the clear message to the market that dependence on traditional ratings is no longer acceptable, reliable or responsible. Investors must look for alternatives and many must deepen their own work.

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS
(4) LOOK-BACK REQUIREMENT

This "look-back" provision is a positive development although it is unlikely to have a major effect. For decades banks have been hiring from the rating agencies into "rating agency advisory" groups dedicated to guiding issuers (bank clients) in how to get the best rating from the agencies. Essentially it has been the most institutionalized form of "ratings shopping" and non-trading "ratings arbitrage" in the market. Forcing disclosure of such employment transitions will put a spotlight on this practice and possibly deter some potentially conflicted hirings from taking place. This is peripheral in the broad scheme of ratings reform however.

The more direct practice of hiring an NRSRO employee is also addressed: "person subject to a credit rating of the nationally recognized statistical rating organization or the issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating of the nationally recognized statistical rating organization."[3] If the employee participated in the ratings process and gets hired by the issuer or banker, this new provision will certainly bring to light, if investigated, any blatant acts of bribery or rewarding of rating agency employees who move from the agency. We doubt there are actually many instances of this happening, but the Dodd-Frank provisions can provide some comfort that there will be a responsibility among NRSROs to bring the possible instances to light.

<u>Negative Developments</u>

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS
(s) TRANSPARENCY OF CREDIT RATING METHODOLOGIES AND INFORMATION REVIEWED

We view the information prescribed for disclosure to be troubling. While we appreciate the intended outcome is to increase disclosure and transparency into ratings, we believe there is potential for a far greater negative effect. The information required as per the Dodd-Frank language will jeopardize the private nature of some ratings intellectual property. Given the

[3] (H.R. 4173, 508)

choice to be an NRSRO and have private property rights at risk and remaining a non-NRSRO, our route is clear. Moreover, we are certain that others who will one day bring innovation to the ratings space will think similarly.

Specifically, the language required in (1) FORM FOR DISCLOSURES, (A) information relating to – "(i) the assumptions underlying the credit rating procedures and methodologies"[4] has, depending on interpretation by the SEC, threatening ramifications. If assumptions underlying methodologies are at one level of depth, that is benign. If it is at a deeper level, it could be probing information that is proprietary and commercially sensitive.

Then in the following two subsections listing qualitative and quantitative disclosure criteria, there are many items which in isolation may or may not be acceptable, but in aggregate present a tremendous threat to intellectual property protection of a ratings firm:

''(3) CONTENT OF FORM.—
''(A) QUALITATIVE CONTENT.—Each nationally recognized statistical rating organization shall disclose on the form developed under paragraph (1)—
''(ii) the main assumptions and principles used in constructing procedures and methodologies, including qualitative methodologies and quantitative inputs and assumptions about the correlation of defaults across underlying assets used in rating structured products;
''(iii) the potential limitations of the credit ratings, and the types of risks excluded from the credit ratings that the nationally recognized statistical rating organization does not comment on, including liquidity, market, and other risks;
''(ix) such additional information as the Commission may require.

''(B) QUANTITATIVE CONTENT.—Each nationally recognized statistical rating organization shall disclose on the form developed under this subsection—
''(i) an explanation or measure of the potential volatility of the credit rating, including—
''(I) any factors that might lead to a change in the credit ratings; and
''(II) the magnitude of the change that a user can expect under different market conditions;
''(ii) information on the content of the rating, including—
''(I) the historical performance of the rating; and
''(iii) information on the sensitivity of the rating to assumptions made by the nationally recognized statistical rating organization, including—
''(I) 5 assumptions made in the ratings process that, without accounting for any other factor,

[4] (H.R. 4173, 504)

would have the greatest impact on a rating if
the assumptions were proven false or inaccurate;
and

''(II) an analysis, using specific examples, of
how each of the 5 assumptions identified under
subclause (I) impacts a rating;
''(iv) such additional information as may be
required by the Commission.[5]

It does appear as though the SEC is interpreting these requirements to pertain only to structured product ratings and as such may not directly apply to Rapid Ratings unless we move into this asset class. However, for other quantitatively oriented firms that want to get into this ratings class, these data requirements are unprecedented and, in the extreme, would allow the reverse engineering of our methodologies. Again, as things stand, the cost benefit calculus of becoming an NRSRO and subjecting ourselves to this disclosure is clear – remain a non-NRSRO.

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

(q) TRANSPARENCY OF RATINGS PERFORMANCE

Accuracy of ratings is a key element of Dodd-Frank Subtitle C. It appears as a justification for the Establishment of Office of Credit Ratings at the SEC, in instructions to the SEC on enforcement of Dodd-Frank provisions, in transparency of ratings performance and in a number of other instances.

There is a subtle but critical distinction that needs to be recognized when discussing accuracy: more accurate ratings are good for the market. Regulatory enforcement of a prescription of accurate ratings is bad for the market. It is not regulations and rules that produce accuracy; it is innovation and competition in the marketplace.

Why are accurate ratings good?

As stated in the preamble to Subtitle C "In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies." The accuracy of Big Three ratings has long been the subject of debate. That debate is strategically important because it makes the incontrovertible argument that accuracy is more important than the "stability" of ratings. The traditional issuer-paid firms have used "rating stability" as a shield to deflect attention from the challenge and charge of "inaccurate ratings."

[5] (H.R. 4173, 505-506)

The Big Three produce ratings that they refer to as "rating through the cycle" as a means of providing "stable" ratings. The concept of rating through the cycle is to have ratings that reflect the longer-term perspective of an issuer at the conclusion of its cycle, rather than reflecting the intra-cycle condition of the company. The result, of course, is ratings that exhibit little or no change because the agency is not continually reflecting any ups and downs the issuer may experience over time. Only when the agency considers a truly material change to warrant a rerating will there be a change. The precipitous drops of homebuilders long after the market knew of the housing crises, Enron's remaining investment grade until hours before it filed for bankruptcy and countless other examples expose the weakness of this methodology.

The Big Three typically defend this position by citing studies that the investment community wants to have ratings stability. While there are studies that document the opposite position, in fairness, many institutional investors do want to avoid volatility in rated portfolios given the inconvenience of frequent portfolio rebalancing. Further, some regulators have supported the view that monitoring firms' capital adequacy frequently is too burdensome on the firms and the regulators. Unfortunately, rating through the cycle means being less sensitive to the short and medium term changes in a credit that make it more or less healthy at any given time. Being rated too low incorrectly has primarily opportunity cost implications. Being rated too high incorrectly can have material real dollar cost implications. Having widespread risk benchmarking correlated to these insensitive measures has real systemic risk cost.

A recently released working paper, *"Does the Bond Market Want Informative Credit Ratings?"* by Cornaggia and Cornaggia[6] tackles the question as to whether market participants benefit more from relatively stable ratings utilizing traditional methodologies than from quantitatively derived ratings that are timely and accurate. Moody's Credit Ratings (MCRs) are employed as a proxy for the Big Three. Cornaggia and Cornaggia categorize the MCRs as compensated by issuers and based on qualitative analysis geared toward stability in rating levels that reflect only relative risk.

In order to test and benchmark MCRs, they select a system that provides contrast on multiple criteria. Cornaggia and Cornaggia write, "The Financial Health Rating (FHR) produced by Rapid

6 Cornaggia J, Cornaggia, K. Does the Bond Market Want Informative Ratings? http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1705843&download=yes. Jess Cornaggia, PhD, is an Assistant professor at Indiana University Bloomington - Kelley School of Business. Kimberly Rodgers Cornaggia, PhD, is an Associate Professor American University - Kogod School of Business. **The authors note**: "To support our use of Rapid Ratings as an exemplar, we note its recognition by regulators, law makers, and market participants. RR was the only non-Big-3 credit rating agency invited to speak on the ratings competition panel at the SEC Roundtable in 2009 and to testify before both congressional bodies in the run up to the most sweeping change in rating agency regulation in history."

Ratings (RR) is compensated by subscribers, based on quantitative models, and geared toward the timely release of information as it pertains to absolute credit risk." [7]

In the body of the working paper, MCRs are tested rigorously for information content against FHRs. The authors write, "We document that among bonds that ultimately default, RR downgrades the FHR to speculative grade status long before the Moody's credit rating follows suit." The data tests speak to the magnitude of these findings demonstrating that Rapid Ratings is 2.9 years earlier than Moody's.

One test in the study compared default frequencies among issues with investment grade ratings. The professors report a higher default frequency among issues with investment grade ratings according to the MCR compared to the FHR, writing "2.61% of defaulting firms had FHRs classified as investment grade one year prior to default." The corresponding number of defaulting firms with investment grade MCRs is 5.67%.

Cornaggia and Cornaggia contextualize these findings with respect to Moody's' stated position that stable ratings help avoid market disruptions. They postulate that gradual ratings downgrades may have disrupted the financial markets less than the huge volatility spikes and losses of investor confidence that accompanied the too-late downgrades of Enron and AIG among others. This bolsters the position of those who have claimed that over-reliance on traditional credit agency ratings increase vulnerability to sudden market shocks.

What are the economic effects of the stability vs accuracy debate?

Wealth effects are also quantified in this study by calculating the differences that would have been realized by trading on the early versus late downgrade. A portfolio manager selling bonds on FHR downgrade would significantly mitigate losses relative to selling at the MCR downgrade. In the study's own words, "The results indicate significant differences in the prices and yields at the various points in time. Prices are significantly lower ($11.70 to $15.40) and yields are significantly higher (5.9% to 9.7%) when Moody's downgrades the bonds to speculative grade than when RR downgrades the bonds' issuers. These results highlight the costly consequences of delaying sales beyond the earlier FHR warning." The authors point out that this result is significant given evidence of "fire sales associated with regulatory compliance."

[7] Gellert, James H. The United States of America. *Competition in the Credit Rating Industry: Are we asking the right questions and getting the right answers?*. Washington: , 2009. Web. 25 Jul 2011. http://www.sec.gov/comments/4-579/4579-20.pdf

Absolute vs Relative Risk

Much is made of the ratings scales that dominate the ratings industry. Symbology and commonality of the scales are referred to often in Dodd-Frank.[8] However, the traditional alpha scale is both ordinal and less informative than the Rapid Ratings' cardinal scale. For instance, ask anyone familiar with ratings what it means to be a "single A credit." Then ask them what it means to be a "BBB credit." Then ask what the difference is between those two. Then ask what it means to be a certain rating this year vs. next year vs last year. None of these questions will have satisfactory answers. The reason is that default associations with each traditional rating letter grade change yearly. And, while users know that an A is better than a BBB, which is better than a BB and so on (relative risk), the distance between them, the magnitude of that distance and the importance relative to health or failure among them is unknown (absolute risk) using the traditional ratings systems.

To highlight this problem, Cornaggia and Cornaggia site as examples the following: "4.1% of bonds rated A3 (investment grade) defaulted in 2003 yet no bonds rated B2 (speculative grade) defaulted in 2007. As another example, 30.6% of bonds rated A1 defaulted in 2008" (extreme example influenced by the Lehman Brothers failure).

The professors add, "We confirm that the FHR better reflects absolute credit risk than the MCR. Default frequency within investment and speculative grade classifications, as indicated by the MCR, varies significantly from year to year. However, default frequency within investment and speculative grade classifications, as indicated by the FHR, exhibits less variation. The distinction between absolute and relative credit ratings has potential implications for efficient capital allocation."[9]

How can ratings accuracy be bad?

Dodd-Frank and the SEC seek to determine what are accurate ratings and what are not, as a means of providing transparency in, and disclosure from, the ratings industry. There is a natural desire to provide insight into how agencies score in getting ratings right, and getting them wrong. In concept this is reasonable except for three important concepts: 1) not all ratings are created to measure the same things; 2) how does one, the SEC or otherwise, determine what is "accurate;" and 3) what happens when all agencies begin producing ratings knowing they will be measured by a specific definition of accuracy?

1. Traditional agencies solve for slightly different definitions of ratings. S&P claims to rate the ability and willingness of an issuer to meet its financial obligations in full and on time. Moody's claims to rate an issuer's likelihood of default and any financial loss

[8] (H.R.: 4173, 510)
[9] (Cornaggia and Cornaggia, 5)

suffered in the event of default. Rapid Ratings provides a firm's Financial Health Rating (FHR), a measure of how efficiently a company is run and how well positioned it is to maintain its competitive position against its global, industry-specific peer group. This measure is highly correlated to defaults (low FHRs to high default histories,) but in fact is not a default measurement. As time goes on, we anticipate other methodologies and ratings standards to also emerge if the market is attractive to new entrants.

2. Rating accuracy is difficult to measure and the SEC has proposed a wide variety of elements for comment covering ratings transitions, default associations, etc. How the SEC will determine what constitutes accuracy is anyone's guess at this stage.

3. In many respects, what is more challenging to imagine than how the SEC will define ratings accuracy, is what happens if they do? In our view the fastest way to positively evolve the ratings industry is for more ratings opinions and innovative ways of measuring risk to be available to the marketplace. If ratings "accuracy" is prescribed by regulation, over time, agencies will naturally engineer ratings to the standard by which they are being measured. Those that become "most accurate" will be those that are least differentiated and most highly correlated. This means fewer diversified opinions, not more. In the end, it should be what the market accepts as the new standard for determining accuracy, rather than regulatory guidance that determines what is accurate and what is not given different investments and conditions. Our concern is based on our knowing that in the ratings industry regulations can have decades-long negative effects.

   In the extreme, if most agencies wish to be viewed as "accurate" and benefit from all that a high accuracy score may provide, the regulatory framework will counter-productively be promoting a homogenization of ratings, not an improvement in the ratings industry.

   If these guidance-based ratings are broadly used in the market, this prescriptive ratings paradigm will increase the systemic risk embedded in the market, not reduce it. Correlating the risk management measures of wide swaths of ratings users could be one of the most short -sighted outcomes conceivable from the entire Dodd-Frank era.

Disclosure of ratings histories

Rule 17g-2[10] requires an NRSRO to provide ratings histories to the public for free in order to allow their ratings to be judged by market players. This topic has been troubling for Rapid Ratings and for others for a number of years. As we assess NRSRO status, the requirement to publish our ratings for free to the market has always been entirely cannibalistic for our revenue model – to get paid by subscribers for our ratings. Nevertheless, when the SEC created the one year embargo for issuer-paid firms and a two year embargo for subscriber-paid firms we thought this was at least more palatable.

Having this distinction between issuer-paid firms and subscriber-paid was a significant development in SEC ratings oversight two years ago. It provided some confidence that the SEC appreciated the distinction between the revenue models and was not trying to paint reform with a wide brush. However, the recent proposed rules by the SEC request comment on the appropriateness of the 1 year and 2 year grace periods. It is disconcerting that the embargo time frames are out for comment again, suggesting the SEC may reconsider their original decision on this topic.

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

'(t) CORPORATE GOVERNANCE, ORGANIZATION, AND MANAGEMENT OF CONFLICTS OF INTEREST

Another perplexing provision of the accountability rules concern Board of Directors composition and governance. As stated:

''(1) BOARD OF DIRECTORS.—Each nationally recognized statistical rating organization shall have a board of directors.
''(2) INDEPENDENT DIRECTORS.—
''(A) IN GENERAL.—At least 1⁄2 of the board of directors, but not fewer than 2 of the members thereof, shall be independent of the nationally recognized statistical rating agency. A portion of the independent directors shall include users of ratings from a nationally recognized statistical rating organization."[11]

[10] *PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934*. Washington: Web. 25 Jul 2011. http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=47b43cbb88844faad586861c05c81595&rgn=div5&view=text&node=17:3.0.1.1.1&idno=17#17:3.0.1.1.1.2.96.408 (Rule 17g-2)
[11] (H.R.: 4173, 507)

There are costs, hidden costs and new conflicts of interest embedded in these rules:

- *"a portion" of directors "shall include users of ratings" from a NRSRO.* This is problematic because the firm will be required to share inside information with an institutional investor

- These outside board members will be terribly conflicted if they indeed work at an institutional investor. The level of detail they would have about capital markets trends, specific information on market players and issues would be stunning and unprecedented for a member of the buy-side of Wall Street. Alternatively, a sell-side professional would be just as conflicted under these circumstances.

- As per section 932 of Dodd-Frank, the board has authority over the ratings methodology. Once again, this means the institutional investors on the board would have access to potentially conflicted data and process information.

- With the increased liability provisions of Dodd-Frank in particular, the role of an NRSRO board member is not that attractive. Given the increased liability, finding someone to take this role could be a challenge and will certainly be costly in terms of compensation

- Directors and Officers insurance is also a significant cost and going higher for NRSROs. One can only imagine the cost, if it is obtainable at all, for a firm when the carriers understand the potential conflicts of interest inherent in having institutional investors on the boards of rating agencies

Dodd-Frank allows for a small company exception for these board rules. However, there is little insight into who qualifies and how a firm adjusts once that exemption becomes disallowed due to growth in size.

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

CONFORMING AMENDMENT SEEMINGLY ELIMINATING THE "THREE YEAR" REQUIREMENT FOR NRSRO APPLICATION[12]

There is an obscure Conforming Amendment that seems to modify an important component of the Credit Rating Agency Reform Act of 2006[13] (CRA Act) requiring new NRSRO applicants to have been rating in an asset class for three years prior to submitting an application. We were encouraged at the initiative to roll back this particularly poor element of the CRA Act. Nevertheless, we understand now that this was an erroneous reference and is being corrected. The result is that indeed the three year requirement stands.

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[12] (H.R. 4173, 508)

[13] United States. Cong. Senate. *Credit Rating Agency Reform Act of 2006.* 109th Cong. 2nd Sess. S. 3850. Washington: GPO, 2006. Web. http://www.gpo.gov/fdsys/pkg/BILLS-109s3850pcs/pdf/BILLS-109s3850pcs.pdf

This was going to be a positive development for industry competition. Many observers were perplexed when the CRA Act included this provision, and it was perceived to be a last minute addition to the drafting of the Act possibly to satisfy a lobbying demand. In essence, the restriction has been a massive barrier to entry to competitors, almost guaranteeing the Big Three were able to maintain their oligopoly in structured products ratings leading up and into the Subprime Crisis. Only one viable new structured product player and NRSRO applicant emerged in the years immediately following the Act and they covered commercial mortgage backed CDOs, and not residential.

From a competitive standpoint, if a ratings firm wishes to become an NRSRO, we believe they should be able to apply and be granted the designation if they are deemed to qualify by the SEC. Practically speaking, having a three year hurdle was likely a disincentive to new players entering over the past few years. Removing this would be a very positive step and having it survive as a key criterion for NRSRO application means there continues to be a significant barrier to entry for new competitors. For asset classes like structured products and municipal ratings, where there are few non-NRSRO players that can demonstrate a three year track record, the closed nature of the club remains.

SEC. 933. STATE OF MIND IN PRIVATE ACTIONS- LIABILITY ISSUES

The increased liability provision of Dodd-Frank facilitates actions against any Credit Rating Agency if they "knowingly or recklessly failed"

''(i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or
''(ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.''[14]

Liability dominated the reform debate throughout 2009 and into the enacting of Dodd-Frank. It is perhaps the most political charged and roundly understood concept for reform by the public at large. It may indeed be fair to levy stricter liability standards on those agencies that made such egregious errors contributing to the crisis. But, facilitating private actions against all CRAs, regardless of whether or not they are NRSROs is a significant barrier to entry not just to the NRSRO club but to companies' getting into ratings in the first place.

[14] (H.R.: 4173-509)

As a quantitative business and one that has no contact whatsoever with issuers in the ratings process, Rapid Ratings is affected somewhat differently than a highly qualitative business and one that focuses on due diligence and issuer contact as their cornerstone. Nevertheless, all ratings firms are experiencing increased legal bills and higher insurance costs of all kinds. The threat of suits, whether meritorious or not, is a concern that all firms have to manage.

The issuer-paid firms have higher risks in this regard since subscriber-paid firms have bilateral subscription contracts with users of their ratings, but it is problematic for all.

A fascinating development as Dodd-Frank was being resolved was the subtle change in language in Sec 933 from NRSRO to "credit rating agency." This change was the only material instance where even non-NRSROs were captured by new statute. The definition of credit rating agency is rather broad and certainly open to interpretation. From the Credit Rating Agency Reform Act of 2006:

SEC. 3. DEFINITIONS.
"(a) SECURITIES EXCHANGE ACT OF 1934.—Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end the following new paragraphs:
''(60) CREDIT RATING.—The term 'credit rating' means an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments.
''(61) CREDIT RATING AGENCY.—The term 'credit rating agency' means any person—
''(A) engaged in the business of issuing credit ratings…"[15]

Without question this definition, and therefore increased liability, is affecting many firms whether they saw themselves as potential NRSRO candidates at some point in the future or not. Nevertheless, any new player looking at entering the market needs to be very sensitive to this increased liability and to make sure they are properly capitalized for the legal costs at set-up and as an ongoing concern.

What it unclear is why this wording change from NRSRO to CRA occurred. The most logical explanation is that the drafters wanted to make sure the liability provision affected the current NRSROs even if the firms decided to unregister as NRSROs. This says to us that the drafters knew there was a chance that the rest of the Dodd-Frank reforms would be so unpalatable to current players that they might try to escape the grasp of the new framework. If true, this is a powerful statement of recognition of the punitive nature of these reforms. One option, if this punitive change remains, is to give a safe harbor to CRAs that have never been NRSROs.

[15] (S. 3850, 3)

Neutral Developments

SEC. 936. QUALIFICATION STANDARDS FOR CREDIT RATING ANALYSTS

Instituting standards of training and competence for NRSRO analysts seems like a perfectly reasonable concept. In response, the SEC has proposed Rule 17g-9(c)[16], which would require the NRSRO to implement standards of testing and experience requirements. Having better trained analysts is a good goal. However, having the NRSRO responsible for designing and implementing the training does little to challenge old ways of thinking with new ways of thinking. "Path dependence" is one of the causes of the financial crisis, so letting the old teach the new within the agencies seems to encourage a perpetuation of old-school thinking.

One of the elements of this new rule would be a requirement for the analysts to understand the measurement of accuracy of ratings. Please refer to page 11 in this submission for thoughts on ratings accuracy and the challenges of requiring this knowledge.

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

(3) SEPARATION OF RATINGS FROM SALES AND MARKETING

The concept of separating sales and marketing from ratings is fine, but too much is made of this as a major initiative; it is marginal, at best. Rule 17g-5, new paragraph (c)(8)[17] prohibits NRSRO employees from participating in both sales and marketing efforts of an NRSRO and also rating securities. This removes the most egregious potential conflict but it is naïve to think that ratings analysts are then somehow insulated from the knowledge that firm success is dependent on ratings business. Every employee at an issuer-paid NRSRO, whether involved with sales or not, knows that they do well if the business does well (whether compensation is directly tied to growth or whether growth simply provides job security) and the business does well if they rate more securities. This was at the heart of the clamor for structured product ratings market share and the degradation of ratings standards that accompanied that land-grab.

Dodd-Frank does provide for small firm exceptions, which is positive. But there is no definition for what is small, or when one might lose its "small' status, or how much flexibility small firms might have. All of that, of course, creates compliance costs to understand and manage the constraints.

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[16] (*PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934*., Rule 17g-9(c))

[17] (*PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934*., Rule 17g-5)

Other Factors

Access to information required for unsolicited ratings

In this entire area of structured product information disclosure, Dodd-Frank provides little improvement. In addition to all the new compliance rules and liability facing new entrants, those same new competitors are offered none of the additional disclosure or information that is required to evaluate, rate, and monitor structured finance vehicles such as CLOs. Prior SEC rules open up access to underlying data used for some structured product, but not for all. Basically, new competitors are offered new risks for little new opportunity. It is a material disincentive against entering the NRSRO and rating agency space.

For example, Collateralized Loan Obligation ("CLO") ratings

CLOs remain a viable asset class unlike many structured finance vehicles of the past several years. CLOs are important in the credit creation process and this helps the economy by allowing more credit to flow to companies beyond what is available from the banks and leveraged loan mutual funds. In CLO structures, the demand for higher risk loans is extended to high grade investors as a result of the higher rated tranching process. The CLO, like subprime RMBS, is another structured finance vehicle with universally high ratings from the rating agencies, and that can be a cause of concern over time depending on the quality of the assumptions and the underlying assets. The ratings process for such securities is stuck in the issuer-paid model and is a captive of the rating oligopoly the Fitzpatrick bill was supposed to help address. Dodd Frank has done nothing to correct some of the insurmountable barriers on the disclosure front.

The lack of disclosure on CLO structures combined with the tendency of originators to sell high risk loans into such structures does create significant risks of "excess" in hot markets that should be more closely monitored by investors. Investors need to do additional due diligence on such securities for their own safety and to reduce reliance on the rating agency oligopoly for models and assumptions.

As vehicles created by underwriters and managers of high risk debt instruments and placed with investment grade holders, the only detailed disclosure is in the hands of the large rating agencies (who award high ratings to the structures), the underwriters that sell the tranches, and the packagers and managers of such instruments. The underlying loan documentation and financial statements of the issuers whose loans have been sold into the structures often include private companies (LBOs etc.) where the high grade, high quality investor cannot gain access to the underlying documentation.

If investors and independent parties such as new rating agencies could gain access to the private companies' loan documents and financial statements packaged into CLOs and also get access to the CLO offering documents, meaningful competition could be brought into the ratings of CLOs. This is not just at new issue but also for purposes of ongoing risk surveillance. Distinct and similar disclosure improvement could also apply to other structured finance instruments. All of this information is readily available despite what lobbying groups will concoct. The idea that such disclosure will chill financings, proffered by some, is a Wall Street sales pitch and in fact a bluff since issuers get less expensive funding and more lenient structures through such vehicles. Dodd Frank does nothing to advance this disclosure and even crystallizes the obstacles by deterring competitors and leaving such disclosure concentrated in the hands of the major agencies. Unnatural barriers to entry in turn stack natural barriers to entry even higher.

The situation with CLOs, is made worse by the regulatory turf questions between the SEC and some of the bank regulators (Fed, OCC, FDIC). CLOs and disclosure rule for the underlying assets should be under the SEC, but the underlying assets (loans) are not securities and fall under the bank regulators (though there is no meaningful regulation of buying and selling bank loans). The fact that high risk assets are being repackaged and sold to high grade investors would seem to call for some more information so investors can defend themselves and rely less on the ratings issued by an oligopoly that gets fees for the high new issue ratings.

New rating agency competitors as well as investors in the CLOs cannot get access to the full range of underlying documents and asset level detail in such structures. Given that CLOs are high risk leveraged loans which are rolled up into investment grade structures in the AAA and AA range, such lack of disclosure leads to reliance on the rating agencies once again.

While these CLO structures did not create the magnitude of toxic problem we saw with subprime RMBS and commercial real estate in this past cycle, the overriding principal is still the same in that there is an *absolute* barrier to entry based on information availability that Dodd Frank fails to recognize or address. Investors end up relying on the agencies and cannot do the level of due diligence themselves given the closed information loop on such structures.[18]

Encouraging or mandating the SEC to revisit the breadth of the 17g-5 information access would be a positive direction. Getting the SEC purview over loans used as collateral for securities would be a significant leap forward. The two combined could lead to meaningful reform.

Corporate Counterparty Risk

When considering CLOs, and the companies that comprise their collateral, it is interesting to note that many international corporations use ratings for risk management purposes of their own. Ratings, from NRSROs, firms like Rapid Ratings as well as "credit bureaus," like Dun & Bradstreet (D&B) and Experian, provide ratings to corporations globally for assessing the risks

[18] "for a well prepared description of the CLO information conundrum, please refer to the April 10, 2009 submission to the SEC by CreditSights' CEO, Glenn Reynolds: http://www.sec.gov/comments/4-579/4579-19.pdf"

of customers (credit extension and accounts receivable management) and supply chain risk management. Interestingly, the credit bureaus are explicitly carved out of the CRA Act despite their providing a series of ratings for companies' risk management. The ratings also get used within financial institutions in vendor management (supply chain risk management) within large financial institutions, insurance companies, hedge funds and others. So, while the discussion about NRSROs is almost always focused on their capital markets' use, it is worth noting that their reach is much broader.

These corporations will often use NRSRO ratings and/or use the credit scoring of companies like D&B (by far the largest market share holder in this space) across their organizations for risk management purposes. Although corporations are much more forward thinking in using non-NRSRO and D&B type services than some institutional asset managers, there are still wide swaths of the corporate market that are correlating their risks on slow to change and rudimentary risk measures like S&P and Moody's ratings and payment-derived scores.

The "Restore Integrity to Credit Rating (Franken) Amendment"[19]

The Franken Amendment creates a government appointed board to distribute asset-backed security rating duties to NRSROs, hypothetically relieving NRSROs from the temptation to inflate ratings to attract issuers. Ratings contracts would be distributed depending on the accuracy of each NRSRO's historical rating record, thereby increasing competition and rewarding rating accuracy. Though these goals are worthy, the Franken Amendment is a poor idea on many levels. The fundamental reason for its creation was to try and prevent conflicts of interest and an oligopolistic paradigm within ratings, yet it addresses this by creating further conflicts of interest and a slightly broader oligopolistic paradigm.

In market practice the Big Three won almost 100% of the structured products ratings business leading into the financial crisis. The Franken Amendment will award business to other qualifying NRSROs that rate structured products too. This includes three other players at present. This means structured product ratings will now be shared around to six players instead of three, but issuers will still get ratings from one or more of the Big Three because they are the recognized names in the market. And, the Big Three can still rate these issues on unsolicited bases and award whatever ratings they would have otherwise. Ultimately, there is little initiative here other than a new issue subsidy redistribution to three more companies. Further, with business being awarded regardless of quality of rating, there will be little impetus for firms to innovate and improve.

[19] Franken, Al. The United States of America. *Restore Integrity to Credit Rating Amendment*. Washington D.C: , 2010. Web. 12 Jul 2011. <http://franken.senate.gov/files/docs/Final_Language_Franken_CRA.pDodd-Frank >. (3)

There are significantly more problems with the Franken Amendment:

- The Amendment gives the Commission power for determining the fees NRSROs can charge. But what happens to the firms if the committee decides to drop fees to an unpalatable level? For this or for any other reason if all the raters who rate an asset class decide to stop en masse, it would cause an international crisis of confidence.
- The amendment presupposes all ratings are the same and their providers are interchangeable. If this is the case, there will be no incentive for new players to innovate and there will be no incentive for the current players to improve
- An issuer that gets assigned a newer agency may disagree with the methodology or the philosophy of that firm's rating (not to mention outcome) and go to one of the Big Three in any event in addition. This will increase the issuer's gross borrowing cost
- Composing the committee will be a significant challenge as it will be full of conflicted parties themselves

Rapid Ratings Proposal for Increased Ratings Accuracy and Integrity

We would like to suggest an addition to the SEC's oversight process that we believe will have significant and meaningful implications to the rating industry reform effort. We would characterize this as a high potential benefit with low regulatory cost initiative. It is motivated by the following:

- Issuer-paid ratings have lost significant credibility
- There are potential conflicts of interest in the issuer-paid revenue model and many market participants believe ratings inflation is the result
- The issuer paid firms tend to have slow to change ratings, as described above
- The principal business model of issuer-paid firms is primarily issuance focused (where they get paid) and less on "maintenance" or "surveillance" ratings, where there is less money and more work
- The SEC has a challenge to oversee ratings performance and, if there are ultimately more NRSROs, this problem will become harder
- Whether we believe it should be or not, liability of ratings firms is an important element of legislative and regulatory reform initiatives

The proposal is both simple in concept and potentially wide reaching in its benefits: Require NRSROs to positively affirm by statement filed with the SEC that they stand by each previously issued rating on a quarterly basis or to make whatever ratings change is appropriate given the changed quality of issuer/security. If deemed to be too costly for the smaller NRSROs, an exemption could be granted with voluntary participation encouraged.

The potential benefits of this initiative are:

- Firms will not be able to hide behind the "our rating is good unless we say otherwise" positioning that permeates the market today
- Firms will have to properly reassure the market that their ratings have been reviewed and that the reputation of the firm is at stake continuously. Given the loss of confidence they have caused, it would be unwise for the Big Three to vehemently protest this initiative
- If a CRA will not attest to a rating on a quarterly basis, both the firm and the rating should be considered suspect
- At least one of the firms requires analysts to reaffirm the ratings for internal use only on a quarterly basis. This initiative would only be requiring them to make public these reaffirmations
- Potentially more ratings will be changed over time as their credit quality in fact changes, as opposed to having the agencies hide behind the rating through the cycle curtain
- Ratings volatility may increase slightly, but ultimately having asset managers responsible for understanding more frequent ratings changes instead of arbitraging stale ratings is a positive development
- Firms will have to think twice about their initial ratings given they will be responsible for attesting to its accuracy from there on out through time. Likely this will lead to less aggressive and more realistic initial ratings when/if there is a question in the minds of the ratings committees deciding on the initial level
- The SEC will have more data from which it can analyze rating agency performance
- If there are significant discrepancies among agencies on an individual security or company rating, the SEC will have the ability to check into the accuracy of the ratings, but in a targeted way highlighted to it from the NRSROs' attestation reporting
- This can be accomplished without an increased burden at the SEC and in fact can be accomplished electronically by pushing some oversight responsibility to the ratings firms themselves while overseen by the Commission

Conclusion

It seems clear the focus of Dodd-Frank was on controlling S&P, Moody's and Fitch with compliance, disclosure and the threat of liability. It was not on increasing the disclosure of information necessary to facilitate competition nor on the consequences of the Dodd-Frank provisions on current or prospective competitors.

The problem of the incumbent ratings paradigm cannot be legislated or regulated away. Only through the myriad efforts will we see meaningful change in this market: reducing investor reliance on NRSROs, removal of NRSRO references from statutes and regulations, increased access to data for analysis by competitors, facilitating not hindering new players, encouraging innovation, encouraging investors to evaluate various risk management factors in decision making combined with reasonable regulatory oversight, incumbent behavior modification and time.

Encouraging choice, and facilitating new players to bring this to the market unimpeded, will over time transform this industry. As case in point, Rapid Ratings' being shown to be 2.9 years ahead of Moody's in identifying companies that ultimately fail is the kind of innovation that is being embraced and will continue to decrease investors' reliance on the status quo.

We are pleased that this committee is taking the opportunity at this time to evaluate the state of affairs and consequences of Dodd-Frank on players such as Rapid Ratings and the effect on the industry overall. There is still much to do.

Thank you

James H. Gellert is Chairman and CEO of Rapid Ratings International, an independent rating and analytics firm that provides ratings of thousands of companies' financial health for corporate credit, supply chain, investment and risk management professionals. Mr. Gellert has been an entrepreneur and financial markets professional for over 20 years. He has worked at various global financial institutions and in smaller companies in advisory and operational roles and has become a recognized authority in matters pertaining to independent research, rating agency regulatory evolution and corporate counterparty risk management.

Mr. Gellert has both run private companies across an array of industries and been an investment banker arranging public and private debt and private equity financings. In banking, Mr. Gellert was Head of Yankee Origination at Deutsche Bank and as a member of Yankee and private placement teams at UBS Securities and Barclays de Zoete Wedd (now Barclays Capital). In aggregate, Mr. Gellert has arranged over $20 billion in financings for industrial companies, financial institutions and sovereign entities from Europe, Australasia and the US.

After leaving banking, Mr Gellert had positions as permanent and interim CEO of a number of technology and information companies, including wireless software and research businesses.

In 2004 Mr. Gellert Co-Founded and became Managing Partner of Howland Partners LLC and in 2006, Howland Securities LLC (member FINRA/SIPC), firms that together provided consulting, business development, capital raising and M&A advisory to companies in the Financial Information and Technology markets. Mr. Gellert sold Howland Securities in 2010.

In February 2007, Mr. Gellert led the team that acquired Rapid Ratings™ from Collection House Ltd and became the Company's Chairman, CEO and President. Running Rapid Ratings is now Mr. Gellert's sole professional role and he has dedicated himself to the innovation of the traditional ratings business as well as the market for corporations' managing the risks of their customers' and suppliers' financial health.

Mr. Gellert has been referenced or featured in publications such as the Wall Street Journal, Barron's, Der Spiegel, etc. and is a frequent guest on business news networks such as Bloomberg TV, CNBC, Fox Business Network and Business News Network in Canada.

Mr. Gellert has testified to the U.S. Senate Committee on Banking, Housing, and Urban Affairs, to the United States House of Representatives' Committee on Financial Services' Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, and is scheduled to testify in July to the United States House of Representatives' Committee on Financial Services' Subcommittee on Oversight and Investigations on the effects of Dodd-Frank on the ratings industry.

He has also been a guest speaker multiple times at the Securities & Exchange Commission and presented to the International Organization of Securities Commissioners ("IOSCO") Standing Committee Six..

Mr. Gellert was an Asian Studies major at Connecticut College (minoring in Japanese) and attended Doshisha University in Kyoto, Japan. Mr. Gellert is a member of various corporate boards and is a Senior Advisor to the board of Village Picture Shows Inc. He is also active in the non-profit and educational worlds, including being a National Board member of Young Audiences/Arts for Learning Inc, the nation's leading source of arts-in-education services and as an Advisory Board member of the Academy of St. Joseph, a private school in Manhattan. Mr. Gellert lives in NYC with his wife and their five year old son.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
James Howland Gellert	Rapid Ratings International Inc.
3. Business Address and telephone number:	
86 Chambers Street, Suite 701 new York, NY 10007	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	

Please attach a copy of this form to your written testimony.

Testimony Concerning:

"The Collapse of MF Global: Part 2"

James H. Gellert

Chairman and CEO

Rapid Ratings International, Inc.

Before the

United States House of Representatives

Committee on Financial Services,

Subcommittee on Oversight and Investigations

February 2, 2012

On behalf of Rapid Ratings' employees, shareholders and subscribers, I would like to thank Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee for asking me to submit testimony for the hearing entitled *The Collapse of MF Global Part 2* before the United States House of Representatives' Committee on Financial Services, Subcommittee on Oversight and Investigations.

MF Global's failure was the latest collapse of a previously respected financial institution to catch much of the market off guard. Rapid Ratings International, Inc. (Rapid Ratings) is pleased to share our understanding of the MF Global deterioration, insight into why the Rapid Ratings Financial Health Rating (FHR™) system provided years of early warning and our conclusions as to why the traditional, issuer-paid rating agencies failed to provide similar service. Finally, we highlight the problems facing rating industry reform and explain our support for the quarterly ratings affirmations bill discussion draft released by Subcommittee member, Congressman Mike Fitzpatrick.

Introduction

Outside of the futures world MF Global may have been little known, but inside it was a very large player,[1] and its demise and aftermath constitute the most shocking event ever to occur in the futures industry. Contributing to the unfortunate story is that this was an entity perceived by many in the market as a strong credit, in part because it carried "investment grade" ratings from the "Big Three" rating firms (Standard & Poor's, Moody's and Fitch) until days prior to its failing.

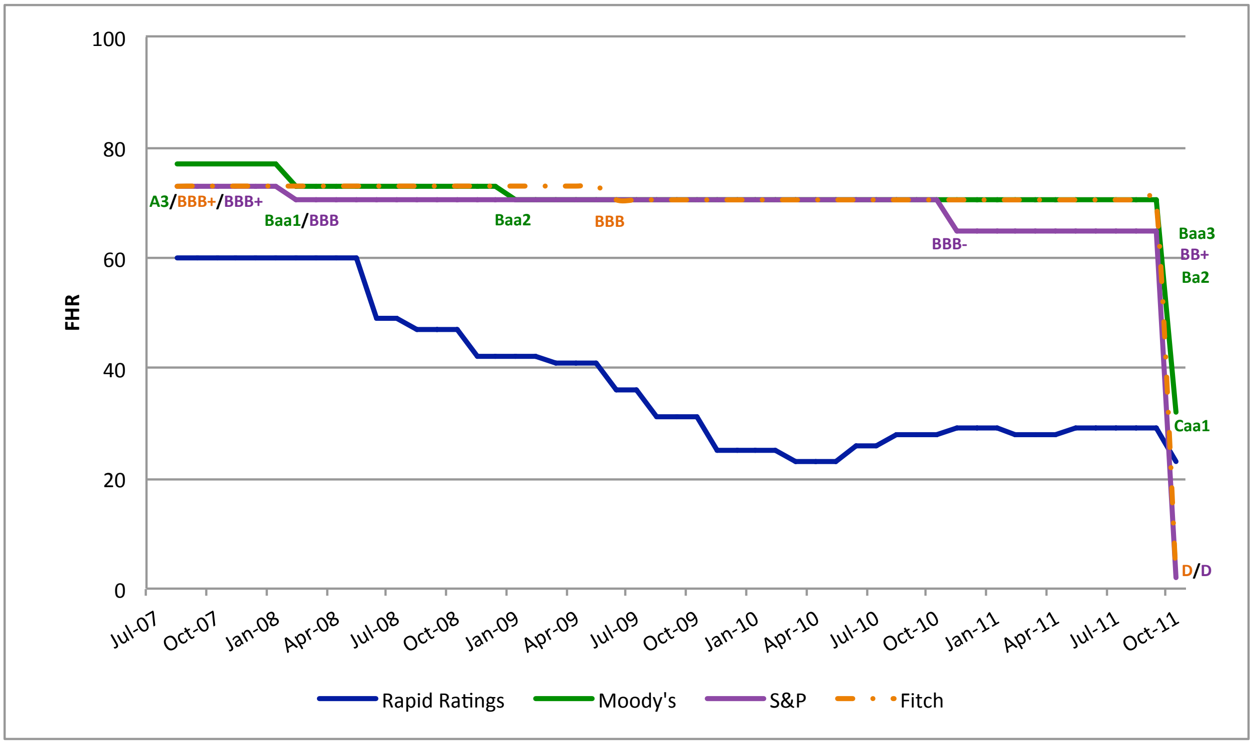
Rapid Ratings, however, had MF Global rated as a High Risk firm since June 2009. In fact, on our Financial Health Rating (FHR) scale (0/worst – 100/best), MF Global was downgraded from a 41 to a 36 on June 29, 2009, carried an FHR of 29 into October 2011, and then dropped even further to a 23 based on the quarterly figures released the week of the MF Global bankruptcy filing. While Financial Health Ratings do not have a direct translation to the alpha scales used by the Big Three, MF Global's 29 and 23 are the approximate equivalents of CCC and CCC-, that is to say, our ratings were between eight and ten alpha notches below where the Big Three agencies had MF Global rated during this period.

For context, over the last 20 years, the greatest concentration of defaults occurred at a 26 on the FHR scale and approximately 90% at 40 and below, which we consider our High Risk and Very High Risk categories. Often Rapid Ratings' FHRs are described as proxies for how well a company is able to withstand an internal or external shock. Companies with higher FHRs are

[1] MF Global was the eighth-largest U.S. futures broker, and a big player in global commodity markets. (Saphir, Ann. "MF Global Client Accounts were not protected: regulator." *The Globe and Mail* 10 Nov 2011. http://m.theglobeandmail.com/globe-investor/mf-global-client-accounts-were-not-protected-regulator/article2221277/?service=mobile)

generally stronger, more efficiently run entities with more flexibility and resiliency. Companies with lower FHRs are less healthy and have a significantly higher likelihood of failure. For more than two years (since June 29, 2009), we continuously gave significant warning to our clients that MF Global had the characteristics of a firm at high risk. And even before that our system was alerting the market of the declining health of MFG (see Figure 1).

Figure 1: Rapid Ratings, Standard & Poor's, Moody's and Fitch ratings of MF Global on the FHR™ Equivalency Scale[2]



As I will explain later, there are many reasons why our ratings were so much lower than the Big Three, but it seems difficult to justify that they maintained such high ratings on MF Global irrespective of our ratings. To the FHR system, which incorporates a global benchmarking of 62 financial ratios, MF Global is a remarkably simple story in many respects: It showed a declining performance since 2007 in various measures of revenue performance, profitability, debt service management, and working capital efficiency, and weak performance in leverage and cost structure. Between the years of 2007 and 2011, MF Global's revenue declined by 63%, from $6.1b to $2.2b. Its net profit declined by 142%, from $190m to negative $79m. In the last 16 quarters, MF Global had 10 quarters with recorded losses and the last 4 quarters saw losses grow by 68% over the previous 12 months, their most recent quarterly loss being a record at $187m.

[2] The graph above plots S&P, Moody's and Fitch ratings based on their approximate equivalents on the Rapid Ratings FHR scale. Rapid Ratings first rated MF Global on January 27, 2009. The previous ratings are retrospective ratings using only data from that time period.

In the abstract, it is difficult to see this entity as being anything but in declining health. Yet, during the period 2007 to 2011 until the final week before MF Global's bankruptcy, Moody's ratings remained Investment Grade and only declined three notches (from A3 to Baa3), and S&P's Investment Grade ratings only declined two notches (from BBB+ to BBB-). In the five days prior to default, Moody's then downgraded two more times, to sub-investment grade Ba2 and then to Caa1 on the bankruptcy filing date.

Much has been made of the European sovereign bond trading bets made by former MF Global CEO, John Corzine. In December, Mr. Corzine testified that his bets on Euro sovereign debt were sound and ultimately would be proven correct and profitable. Nevertheless, these bets were market contrarian and exposed the firm to significantly greater risks than ever before, at a time when the firm's financial health could ill afford a shock and the market's sensitivity to financial institution risk was on high alert. The question is not whether the trades would have worked; it is whether they were appropriate in scale for this institution at this time. Many a trader has made money on contrarian bets; but this institution was historically a pure intermediary, assuming unprecedented risks in a volatile market while shifting business models with a low capital base. Thus, the firm became excessively exposed. In turn, the large rating agencies, watched by much of the market to provide signals of increased risk and vulnerability, failed to do either adequately.

Many are trying to understand why the Big Three rating firms maintained such high ratings despite the obvious evidence of declining health and increased risk-taking. Rapid Ratings incorporates no subjective factors into the FHR system, and we use only reported financial statements when rating public entities like MF Global.[3] Nevertheless, we were able to identify the risks that the Big Three did not identify, chose to disregard or deemed not to warrant material downgrades.

We are not privy to the inner workings of the Big Three's ratings analyses of MF Global. However, in their various ratings reports and announcements on MF Global over the years, repeated themes emerge. These can be categorized as concern about:

- Risk management
- Lack of revenue diversification
- Declining profitability

Despite maintaining MF Global's investment grade ratings for years with only occasional small ratings movements, the agencies finally downgraded MF Global's ratings days and hours before the bankruptcy filing, with a list of rationales for their downgrades. What were they? The same items listed above. In other words, the Big Three offered no new information in downgrading

[3] Rapid Ratings also rates thousands of private companies on behalf of clients. We use financial data provided to us by our clients or directly by the entities being rated on behalf of our clients.

MF Global. The quantum of exposures and losses may have grown, but ultimately, although the fundamentals of the credit story were known by the agencies, their warnings were inadequate until it was too late. That said, new information may suggest that at least one of the Big Three simply apparently did not pay attention to certain disclosures that may or may not have been factors in their ratings process earlier in 2011. Or perhaps the agency did not inquire about the details of the disclosures.[4]

Additionally, there are inherent conflicts of interest and other deficiencies of the Big Three's business model that appear to have contributed to the MF Global debacle. Those deficiencies are not new, rather they are the same issues that have caused examples of egregious ratings failure from Enron, to subprime-backed Collateralized Debt Obligations, to Monoline Insurers, to MF Global. The deficiencies, explored in greater depth below, are:

- The conflicts of interest in the issuer-paid ratings business model, including interaction with management like Mr. Corzine
- The failure of qualitative ratings to look at the agency's rated clients objectively on consistent, arms-length bases
- The favoring of "stable" ratings that results in infrequent ratings changes and less accuracy
- The lack of accountability for surveillance on outstanding ratings

MF Global has shaken the roots of the futures industry, but the case offers lessons far beyond this specialized portion of the capital markets. The futures industry players now understand what corporations globally have also begun to recognize: evaluating counterparty risk is more important than ever before. Doing so gives insight into the financial health and viability of broker/dealers, depository institutions, customers, suppliers, third party solutions providers and any counterparty with which they do business.

There are few silver linings to the MF Global debacle. One small positive, however, is that we have a fresh example to allow scrutiny of the traditional rating agencies' role in the capital markets, the inherent conflicts and flaws in this system, and the patently obvious need to increase their accountability for their ratings product.

While we regularly outperform the traditional agencies in providing early warnings of companies' improving or deteriorating financial health, we do not take a view that the Rapid Ratings' system is simply "better" than others, nor do we believe that traditional ratings are always flawed. Ultimately, we have different business models and rating methodologies, but

[4] On January 29, 2012, Shahien Nasiripour wrote in the *Financial Times* that "Moody's Investors Service 'did not have any understanding' that MF Global, the failed futures broker, had placed a $6.3bn proprietary bet on the debt of troubled European sovereigns until about a week before the brokerage filed for bankruptcy, despite MF Global's disclosure of the gamble some five months earlier in May." (Nasiripour, Shahien. "Ratings agencies to be quizzed over MF Global." *Financial Times* 29 Jan 2012. http://www.ft.com/intl/cms/s/0/7546a9ee-4a88-11e1-8110-00144feabdc0.html

our ratings may be used by the same clients for similar purposes. We are proponents of having an open field for competition in the ratings business so institutional investors, regulators and all other users of ratings can choose amongst options that best suit their needs. A principal strategy for creating better results in the rating industry is for regulators and legislators to remove barriers to competition. That will provide market players a more diverse selection of rating products from which to choose.

The Big Three have received unprecedented support as private sector entities for years by virtue of being embedded in the investment community's workflow practices, in federal regulations, where historically the Big Three were effectively deputized as risk management agents, in state regulations, private contracts, bank pricing grids, pension parameters, institutional investors' internal risk guidelines and on and on. Nevertheless, change can happen with effort. As legislative and regulatory reform initiatives continue, and as Congress evaluates the effectiveness of Dodd-Frank, as it did when this Subcommittee met on July 27, 2011 at a hearing entitled "Oversight of the Credit Rating Agencies Post Dodd-Frank," enhanced competition in the rating industry, greater accountability of the Big Three, and reduced reliance on ratings must be principal objectives.

As the MF Global failure and this review demonstrate, diversification of opinion, methodology and business model are all healthy for the rating industry and critical to facilitating well-rounded investment management and risk management procedures in the capital markets. Any initiative that hinders these goals and continues to support the Big Three agencies' entrenched position actively works against reducing systemic risk and improving confidence in the financial markets. Any thoughtful initiative to improve the industry should be strongly considered.

Congressman Fitzpatrick's recent bill discussion draft is timely and pertinent to MF Global. Requiring Nationally Recognized Statistical Rating Agencies ("NRSROs") to stand by their product on a quarterly basis is a positive initiative. As MF Global shows us yet again, the Big Three have a powerful place in the capital markets, yet almost no accountability when their ratings fail. They are not required to update ratings except when they feel it appropriate. They may indeed be timely on some ratings actions, but often they are not. The outside world has no way of knowing when they are being proactive, behind schedule or simply inattentive to maintenance of an existing rating. The bill's intent, we believe, is not to force ratings to change quarterly; it is to require that the agencies assure the market that they stand by their ratings quarterly. At a bare minimum, it should produce more confidence that the agencies are accountable. In some cases, like with MF Global, perhaps it would have encouraged earlier ratings changes, as agencies would be less inclined to give management benefit of the doubt, or to ignore the clear signs of a credit in decline.

Rapid Ratings' Methodology

Rapid Ratings is a user-paid firm, not an issuer-paid agency. We utilize our proprietary, software-based system to rate the financial health of thousands of public and private companies and financial institutions quarterly (in countries where quarterly financials are available). Currently, we rate over 6,500 public, and thousands of private, companies from 71 countries. We use only financial statements, no market inputs, have no qualitative analysts, and have no contact in the rating process with issuers, bankers or advisors. We are not a Nationally Recognized Statistical Rating Organization (NRSRO). We have elected not to apply for the designation, considering it more a contingent liability than an asset. Our ratings have an impressive record of far outperforming the traditional issuer-paid rating agencies in innumerable cases, and also generally outperforming the prevalent market-based default probability models.

We rate companies irrespective of whether they are bond issuers. We also do not distinguish between those companies that are issuing new securities versus those who have securities outstanding. Unlike the Big Three, we are focused on providing quarterly updated ratings, as well as the highest accuracy, breadth of coverage and speed to market to reflect the changing financial health profiles of firms we rate. The Big Three are naturally focused on primary issuance, where they traditionally get paid the majority of their fees; risk surveillance of ratings already issued is a secondary focus. This is one of the great failings of the incumbent system, and a perfect example of where a new player employing an innovative methodology can provide great value relative to the status quo.

The Financial Health Rating is a strict metric of financial and operating efficiency, derived from the in-depth study of 62 ratios across six performance categories without reference to market inputs or management explanation. The FHR measures a company's sturdiness and ability to withstand shocks from the economy, industry trends, or its own discrete misfortunes. Clients using Rapid Ratings' FHRs on MF Global were in the unique position to know, well before the bankruptcy filing, that MF Global had a weakened likelihood of surviving major reversals in its proprietary trading book, liquidity position or other shocks to the system.

Financial Health Ratings of MF Global

When MF Global filed for bankruptcy on October 31, 2011, it was the fifth largest bankruptcy of a financial institution in American history (following Lehman Brothers Holdings Inc., Washington

Mutual Inc., CIT Group Inc. and Conseco Inc.[5]), and the eighth largest bankruptcy of any institution in American history.

Many broad issues come up because of the MF Global collapse: The weaknesses in regulatory oversight of financial institutions, the deficiencies of accounting/auditing analysis, the lack of security of customer deposits, the challenge to the faith of farmers and others in using agricultural derivatives to hedge revenue fluctuations, the lack of confidence among futures market participants in counterparty financial risk, and once again, the lack of accountability of traditional rating agencies.

What Rapid Ratings' System Saw and When

See Appendix D for a timeline highlighting the events and ratings actions that preceded the collapse of MF Global.

On March 23, 2010 Mr. Corzine[6] became CEO of MF Global at the invitation of his former Goldman Sachs colleague, J. Christopher Flowers,[7] who had earlier bought 6% of the firm in 2008 by helping it finance $141 million in losses in unauthorized wheat trading.[8] Based on the FHR system, MF Global by March 2010 was already High Risk in debt service management, Very High Risk in both sales performance and overall profitability, mediocre in terms of leverage,[9] under-nourished in terms of equity-backing, and with sub-investment grade performance for both working capital efficiency (including liquidity) and cost structure. The rating changes after Q2 2010 are more marginal changes; the company took the big hits before Q3 2010 and never recovered.

Mr. Corzine's strategy of shifting business activity from futures brokerage to a full service broker-dealer in the Goldman image was risky. It included proprietary trading that involved going against growing market sentiment in Euro-zone sovereign bonds by using short-term loans in the repo market to hold long positions. This only deepened the problems of MF Global, and ultimately directly and indirectly led to the collapse of the company.[10] Had MF Global

[5] "20 Largest Public Company Financial Industry Bankruptcy Filings 1980-Present." BankruptcyData.com. Website. http://www.bankruptcydata.com/Research/Largest_Financial.pdf

[6] Former head of Goldman Sachs and former Governor of New Jersey.

[7] A wealthy former institutional banker with Goldman Sachs. Both men were considered to be well aware of the risks they were taking punting on Euro-sovereign bonds. (Cohan, William. "MF Signs Death Warrant for Short-Term Funding." *Businessweek* 15 Nov 2011. http://www.businessweek.com/news/2011-11-15/mf-signs-death-warrant-for-short-term-funding-william-d-cohan.html)

[8] Dezember, Ryan. "MF Global and Chris Flowers: A Match Made for Rescue?" *Wall Street Journal* 30 Oct 2011. http://blogs.wsj.com/deals/2011/10/30/mf-global-and-chris-flowers-a-match-made-for-rescue/

[9] MF Global's equity to assets ratio actually improved over the period 2006-2012, although leverage was excessive. The problem with MF Global's leverage was borrowing short to buy long positions in a poorly understood market combined with poor sales and profitability and hence debt service management performance, rather than over-leverage per se. However, unlike banks, U.S. brokerage firms are not subject to regulatory restrictions on leverage by federal authorities.

MF Global	2006	2007	2008	2009	2010	2011	2012
Equity/assets	1.1%	1.0%	2.6%	3.7%	2.7%	3.7%	3.3%

[10] "MF ploughed money into an off-balance-sheet maneuver known as a *repo*, or sale and repurchase agreement. A repo involves a firm borrowing money and putting up assets as collateral, assets it promises to repurchase later. Repos are a common way for firms to generate money but are not normally off-balance sheet and are instead treated as "financing" under accountancy rules. MF Global used a version of an

offered a lower risk foundation, MF Global might have been able to withstand the failure of the new business strategy. As it was, Mr. Corzine inherited an unhealthy company and made it worse by some high-stakes gambles.

From the beginning of Mr. Corzine's tenure, MF Global was behind the Financial Health Rating eight ball. The firm was suffering in various performance categories within the FHR system: on Sales Performance, on Profitability, on Debt Service Management, as well as on financial strategy (borrowing short to hold long positions) and on business strategy (trying to beat the Euro-zone bond market while avoiding massive market, counterparty and regulatory concern about the magnitude of the exposure).

Because his business strategy was poorly calculated, or had insufficient time to turnaround the firm, those three factors deteriorated and led to further decline in the Financial Health Rating of the company. This made it much more likely that his short term lenders would become restless and then desert MF Global, just as similar lenders had deserted Bear Stearns and Lehman Brothers in 2008. More specifically, the key highlights were as follows:

- MF Global's **Overall Profit performance** (using 23 ratios) had not been low or moderate risk for the last six years and exhibited persistent deterioration and then stagnation in the Very High Risk zone. During 2006 through Q1 2009, the company's profit performance slipped from a medium risk peak of 59 in 2007 to 40, bordering on High Risk. Just one year later, in Q2 2010, MF Global's overall profit performance had become Very High Risk, falling to 12. The firm's profit performance remained in the Very High Risk area until it collapsed on October 31, 2011. See **Appendix A** for one example of a profit ratio that shows sustained deterioration and weakness across the period.
- MF Global's **Debt Service Management performance** (using 3 ratios) was below average and medium risk during the period 2006 through Q1 2010. In Q2 2010, MF's debt service management performance fell 29% (or 12 rating points) to become High Risk, and did not recover. A specific example of deterioration in this area is set out in **Appendix A**.
- MF Global's **Sales performance** (using 5 ratios) was a tale of mediocrity during 2006-2007 that became a story of High Risk in Q1 2009, Very High Risk in the 2009 year end results, and no improvement afterward. An example of the deterioration in performance is presented in **Appendix A.**

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off-balance-sheet repo called a "repo-to-maturity." The repo-to-maturity involved borrowing billions of dollars backed by huge sums of sovereign debt, all of which was due to expire at the same time as the loan itself. With the collateral and the loans becoming due simultaneously, MF Global was entitled to treat the transaction as a "sale" under U.S. GAAP. This allowed the firm to move $16.5 billion off its balance sheet, most of it debt from Italy, Spain, Belgium, Portugal and Ireland." (Elias, Christopher. "MF Global and the great Wall St re-hypothecation scandal." *Reuters News & Insight* 7 Dec 2011. http://newsandinsight.thomsonreuters.com/Securities/Insight/2011/12_-_December/MF_Global_and_the_great_Wall_St_re-hypothecation_scandal/)

A key point about the FHR system is that because its early warnings had fully reflected emerging risk in 2008-2010, as the last minute shocks of the MF Global crisis emerged in October 2011 and the Big 3 ratings were making significant adjustments to move MF Global to a lower rating, Rapid Ratings' FHRs were adjusting very little. The advantage of Rapid Ratings' quarterly rating system is that it catches changes as they arise; it is not a "flatlining" metric that changes a long time after risks arise. The story of MF Global is one of a company that was weakening progressively during 2008-2010, and when Mr. Corzine's arrival brought on a new business strategy, it did not work. Given that the company was already weak, it could not recover or instil confidence in lenders for a new lease on life.

Insensitivity of Traditional Ratings

Ratings "Stability"

The ratings story of MF Global inevitably turns to questions of ratings actions and their timing. Traditional agencies will say that they need to be careful when they take action against a company because their ratings changes will affect that issuer in the marketplace. To wit, a downgrade to below investment grade will force some institutional investors that are prohibited from holding sub-investment grade paper to liquidate holdings. Enough of these forced sellers and there is downward pressure on bonds' pricing, increasing their real or perceived risk in the market, increasing borrowing cost for the issuer and potentially putting even more stress on an issuer that is already distressed, thus aggravating or intensifying the original downgrade.

This is a real concern. It should not, however, be a categorical shield from responsibility for the traditional agencies, nor an excuse for them to be inactive or to give undue benefit of the doubt to a deteriorating issuer.

As stated in the preamble to Dodd-Frank[11] Subtitle C: "In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies." The accuracy of Big Three ratings has long been the subject of debate. That debate is strategically important because it makes the argument that accuracy is more important than the "stability" of ratings. The traditional issuer-paid firms have used "rating stability" as a shield to deflect attention from the challenge and charge of "inaccurate ratings." Accurate ratings provide earlier warnings, stable ratings do not.

[11] United States. Cong. House of Representatives. *Dodd-Frank Wall Street Reform and Consumer Protection Act.* 111th Cong., 2nd sess. H.R. 4173. Washington: GPO, 2010. (508) http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf

The Big Three produce "stable" ratings by means of "rating through the cycle." The intent of rating through the cycle is to have ratings that reflect the longer-term perspective of an issuer at the conclusion of its cycle, rather than reflecting the intra-cycle conditions and performance variations of the company. The result, of course, is ratings that exhibit little or no change (flatlining) because the agency is not continually reflecting any ups and downs the issuer may experience over time. Only when the agency considers a truly material change to warrant a rerating will there be a change. Enron remaining investment grade until hours before it filed for bankruptcy, MF Global and countless other examples expose the costly Achilles heel of this methodology.

The Big Three typically defend this position by citing studies that suggest that the investment community wants ratings stability. While there are studies that document the opposite position, in fairness, many institutional investors do want to avoid volatility in rated portfolios given the inconvenience of frequent portfolio rebalancing and their ability to arbitrage stale ratings. Further, some regulators have supported the view that monitoring firms' capital adequacy frequently is too burdensome on the firms and the regulators. Unfortunately, rating through the cycle means being less sensitive to the short-and medium-term changes in a credit that make it more or less healthy at any given time but that may be early indicators of long-term change. An unwarranted low rating primarily has opportunity cost implications. An unwarranted high rating, as with MF Global, can have material real dollar cost implications for lenders, investors and counterparties. Having widespread risk benchmarking correlated to these insensitive measures has real systemic risk impact.

Within reason, some ratings changeability may benefit the market. We are not promoting volatile ratings swings, but realistic changes can benefit the market, and in the extreme, even changes that have severe consequences for an issuer may have positive overall consequences. As default approached in the last 12 months, ratings on MF Global issued by Rapid Ratings were much more stable than those offered by the Big 3. The rule should be: change ratings when warranted, affirm them quarterly and reflect emerging reality. That will offer early warnings and rating stability that already encapsulates emerging risk as a crisis draws nearer.

In the case of MF Global, S&P, Moody's and Fitch all maintained investment grade ratings on the company as it deteriorated. This was neither an early warning of inherent risks nor a reflection of emerging risks. Moody's maintained an investment grade rating (Baa2) until four days before MF Global filed for bankruptcy, at which time it had downgraded the entity to Ba2, two notches below investment grade. It is possible that the Moody's downgrade accelerated MF Global's demise. But client withdrawals (including Koch Industries) from August through October[12] and regulatory intervention by FINRA, CME and CFTC was already providing a major

[12] Prezioso, Jeanine. "Insight: Clients who fled MF Global face clawback risk." *Reuters* 11 Nov 2011. http://www.reuters.com/article/2011/11/11/us-mfglobal-clawback-f-idUSTRE7AA38A20111111

alert, albeit a late one, that MF Global was in trouble before the Big Three acted. The downgrade to below investment grade may indeed have been an event from which MF Global couldn't recover, as counterparty liquidity may have dried up as a result of the regulatory intervention and the downgrade just as collateral calls were increasing. But as we now know, MF Global was already bleeding client funds before the regulators, and rating agencies made it worse. Market whispers in the equity market were a better early warning signal than either the regulators or the Big Three rating agencies. But if the downgrades had been issued earlier, the MF Global crisis could have unfolded differently. So if the traditional agencies argue downgrades should not happen before a crisis, what good are downgrades after a crisis?

The Subcommittee should consider the cost of accepting the Big Three's argument that they did not need to downgrade earlier. What is at stake is futures market stability, consumer confidence and potentially over $1 billion in account holder funds. If Moody's or S&P had downgraded MF Global earlier, how much of segregated funds could have been saved? Assuming there was a direct cause and effect between Moody's downgrade and the death knell for MF Global, is it conceivable that an earlier precipitation of this event could have forestalled any activities that have led to capital loss for individual and institutional investors with funds that are still not located and possibly never recoverable?

A recently released working paper, *"Does the Bond Market Want Informative Credit Ratings?"* by Cornaggia and Cornaggia,[13] tackles the question as to whether market participants benefit more from relatively stable ratings utilizing traditional methodologies than from quantitatively derived ratings that are timely and accurate. Moody's Credit Ratings (MCRs) are employed as a proxy for the Big Three. Cornaggia and Cornaggia categorize the MCRs as compensated by issuers and based on qualitative analysis geared toward stability in rating levels that reflect only relative risk.

In order to test and benchmark MCRs, they select a rating system that provides contrast on multiple criteria. Cornaggia and Cornaggia write, "The Financial Health Rating (FHR) produced by Rapid Ratings (RR) is compensated by subscribers, based on quantitative models, and geared toward the timely release of information as it pertains to absolute credit risk."[14]

In the body of the working paper, MCRs are tested rigorously for information content against FHRs. The authors write, "We document that among bonds that ultimately default, RR

13 Jess Cornaggia, PhD, is an Assistant professor at Indiana University Bloomington - Kelley School of Business. Kimberly Rodgers Cornaggia, PhD, is an Associate Professor American University - Kogod School of Business. The authors' note reads: "To support our use of Rapid Ratings as an exemplar, we note its recognition by regulators, law makers, and market participants. RR was the only non-Big-3 credit rating agency invited to speak on the ratings competition panel at the SEC Roundtable in 2009 and to testify before both congressional bodies in the run up to the most sweeping change in rating agency regulation in history." (Cornaggia J, and Cornaggia, K. *Does the Bond Market Want Informative Ratings?* 2 May 2011. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1705843&download=yes)

14 Gellert, James H. The United States of America. *Competition in the Credit Rating Industry: Are we asking the right questions and getting the right answers?* Washington: 2009. Web. 25 Jul 2011. http://www.sec.gov/comments/4-579/4579-20.pdf

downgrades the FHR to speculative grade status long before the Moody's credit rating follows suit." The data tests speak to the magnitude of these findings: They demonstrate that Rapid Ratings is 2.9 years earlier than Moody's.

One test in the study compared default frequencies among issues with investment grade ratings. The professors report a higher default frequency among issues with investment grade ratings according to the MCR compared to the FHR, writing "2.61% of defaulting firms had FHRs classified as investment grade one year prior to default." The corresponding number of defaulting firms with investment grade MCRs is 5.67%.

Cornaggia and Cornaggia contextualize these findings with respect to Moody's' stated position that stable ratings help avoid market disruptions. They postulate that gradual ratings downgrades may have disrupted the financial markets less than the huge volatility spikes and losses of investor confidence that accompanied the too-late downgrades of Enron and AIG among others, which now includes MF Global. This bolsters the position of those who have claimed that over-reliance on traditional credit agency ratings increase vulnerability to sudden market shocks. This is a critical issue. Rapid Ratings provides early warnings that the market can absorb long before a crisis, whereas the Big Three provide ratings that can compound a crisis as it reaches its climax.

The Qualitative Unknown of Management Influence

Another reason for the flatlining ratings from the Big Three is that downgrades aggravate their principal clients, the issuers, and issuers' bankers, who feed significant revenue flows to the agencies. As issuer-paid agencies, the Big Three's client was MF Global, not institutional investors. This means an issuer has unique access to the staff of its rating agencies and can present its vision of the future, explain how it is addressing weaknesses and exploiting strengths and, in the extreme, co-opt the raters.[15]

For certain the most egregious examples of this conflict have been in structured product ratings, not plain vanilla corporate ratings such as MF Global. However, it stands to reason that Mr. Corzine's star power was, at the margin, a positive influence on MF Global's ratings. How much so? We cannot tell. But in the face of the firm's clear indicators of deterioration, something powerful must have been weighing on the Big Three to justify their high ratings. In a report written by Moody's on March 23, 2010 commenting on the departure of MF Global's prior CEO and the arrival of Mr. Corzine as the new CEO, they state "Potential concerns about the unexpected nature of the leadership change are tempered by Mr. Corzine's decades of first-

[15] As reported by the *New York Times* in October 2008, documents used in a hearing of the House Committee on Oversight and Government Reform, Moody's CEO Ray McDaniel said in an internal board presentation to Moody's directors in October 2007, "Analysts and managing directors 'are continually 'pitched' by bankers, issuers, investors.' At times, he conceded, 'we drink the Kool-Aid.'" (Morgenson, Gretchen. "Credit Rating Agency Heads Grilled by Lawmakers." *New York Times* 22 Oct 2008. http://www.nytimes.com/2008/10/23/business/economy/23rating.html)

rate industry and leadership experience, as well as the reputational 'cache' and potential industry connections he would bring to MF." One can easily imagine that at least one of the Big Three gave the benefit of the doubt to MF Global's decisions and risk-taking based on their holding Mr. Corzine himself in high esteem.

Reform Initiative Addressing Ratings Accountability

After myriad examples of ratings failures over the years, a new reform initiative is addressing this topic of stale ratings, ratings "surveillance" and the accuracy of ratings over time. Subcommittee member Congressman Fitzpatrick has released a discussion draft of a "Quarterly Attestation Requirement" Bill that targets these issues. This simple yet potentially wide-reaching Bill would be the first effort to make the Big Three agencies, as well as other NRSROs, explicitly "stand by their product." We would characterize this initiative as having high potential benefit with low regulatory cost. It is motivated by the following:

- Issuer-paid ratings have lost significant credibility.
- There are potential conflicts of interest in the issuer-paid revenue model and many market participants believe ratings inflation is the result.
- The issuer-paid firms have been slow to change ratings, as clearly evidenced by MF Global.
- The principal business model of issuer-paid firms is primarily focused on issuance (in other words, where they get paid) and less on "maintenance" or surveillance ratings, where there is less money and more work.
- The SEC has a challenge to oversee ratings performance, which will become harder if there are ultimately more NRSROs.

The Quarterly Attestation Requirement proposal is both simple in concept and potentially wide reaching in its benefits: Require NRSROs to positively affirm by statement filed with the SEC that they stand by each previously issued rating, or have made whatever ratings change is appropriate given the changed quality of issuer/security, on a quarterly basis. If deemed to be too costly for the smaller NRSROs, an exemption could be granted with voluntary participation encouraged.

The **potential benefits** of this initiative are:

- **Greater transparency and timeliness:** Firms will not be able to hide behind the "our rating is good unless we say otherwise" positioning that permeates the market today. This may lead to fewer improperly aggressive/optimistic initial ratings.

- **Greater CRA commitment to their reputation:** Firms will have to properly reassure the market that their ratings have been reviewed and that the reputation of the firm is continuously at stake.
- **Greater sensitivity to risk changes**: Potentially more ratings will be changed over time as issuers' credit quality in fact changes.
- **More active market participation by investors:** More frequent communication by agencies to the market about their ratings, whether those ratings change or not, may be a good market catalyst for investors to do more research and due diligence on their own. Over time, this reduces overreliance on the NRSROs.
- **More data for the SEC:** the SEC requires more data from which to analyze rating agency performance and to provide oversight of agencies' implementation of new methodologies:
    - If there are significant discrepancies among agencies on an individual security or company rating, the SEC will have the ability to check into the accuracy of the ratings, but in a targeted way informed by NRSROs' attestation reporting. This can be accomplished without an increased burden for the SEC.
    - Additionally, in the SEC's 2011 first annual report on NRSRO oversight, the Commission identified instances of both large and small NRSROs that had reformed rating methodologies, but were slow to implement the new methods. This creates a discrepancy between the ratings they issue to the market and those their new methodology suggests are more accurate. Quarterly affirmations would compel an NRSRO to expeditiously implement new methodologies, affording the market the benefit of the theoretically improved rating insight.

Most efforts to introduce legislation to reform ratings have been wide sweeping and have covered massive ground, such as the rating components of Dodd-Frank. The Fitzpatrick Bill is a straightforward and targeted initiative that warrants significant attention and consideration.

Regulatory and Legislative Activities Affecting the Rating Industry

The more sweeping legislative and regulatory initiatives that have been put in place over the past five to six years are complex. They are also a mix of positive and counterproductive elements. Many of them are products of Dodd-Frank, the Securities and Exchange Commission's (SEC) implementing regulations and SEC rules implemented in 2009. The 2006 Credit Rating Agency Reform Act (CRA Act) is also a primary framework that instructs NRSRO criteria and activities.

Dodd-Frank does not do much to foster true competition in the market, and depending on how the SEC decides to implement its new oversight responsibilities, may even directly hinder it. The CRA Act and SEC rules also have idiosyncrasies that run counter to advancing industry reform. The problems include:

- **Material cost increases for smaller NRSROs evidenced by legal, administrative and compliance expenses, board compensation, insurance costs, and more:** These result from Dodd-Frank's emphasis on reporting requirements and legal liability for agencies, and are strong disincentives to becoming an NRSRO
- **Overreliance on NRSROs due to NRSRO references embedded in federal and state regulations, investment charters, bank agreements and others:** Dodd-Frank requires Federal agencies to remove references to NRSROs but that has yet to happen across agencies and only goes as far as the federal agencies. The problem is much deeper, and the embedding is much more prevalent beyond the federal level. There is also growing resistance from some quarters, for example banks[16]
- **Inadequate information availability under Sec Rule 17g-5:** SEC rule 17g-5 allows for an NRSRO to access the data used by another NRSRO hired to rate a structured product. This allows for unsolicited ratings and, in theory, more rating opinions in the market. But the rule only pertains to new issues, and not the information used by agencies to monitor all the outstanding ratings. Given there is *de minimis* new issuance in the structured market, this is of limited value. Also, this provision does not extend to Collateralized Loan Obligations, a still viable structured product type, because the underlying loans are out of the SEC's purview
- **Restrictive three-year qualification requirement for NRSRO application:** The CRA Act requires that a firm be providing ratings within an asset class for three years prior to applying for that asset class' NRSRO license. This effectively blocks most potential applicants from entering the business or expanding their business into a new asset class. This should be dropped or the SEC should have wide authority to waive the requirement
- **The ill-conceived Franken Amendment initiative:** Rotating agencies for structured product ratings is a flawed idea. The fundamental problems in structured product ratings going into the subprime crisis were conflicts of interest and an oligopolistic paradigm within ratings. The Franken Amendment attempts to correct this by creating further conflicts of interest in the form of a committee of conflicted parties to administer the rotation of rating agencies; it also creates a slightly broader oligopolistic paradigm by rotating among the slightly broader group of firms with their structured product NRSRO license. Given the three-year requirement detailed above, new players

[16] Braithwaite, Tom. "Banks warn rule change will hurt recovery." *Financial Times* 29 Jan 2012. http://www.ft.com/intl/cms/s/0/a84eccea-4a79-11e1-8110-00144feabdc0.html#axzz1ktXqHP90

would have a very challenging time becoming an NRSRO in structured products, making the loop of players in this asset class almost completely closed

- **An overall lack of intellectual property protection for newer rating agencies:** SEC implementation rules from Dodd-Frank may require disclosure of the IP underlying model-based ratings. Further, elements of Dodd-Frank that require agencies to disclose assumptions that can change ratings may facilitate attempts to reverse engineer model-based rating systems
- **Dangerous movement towards prescribing ratings "accuracy" criteria:** To try to increase ratings accuracy is a worthy goal, but Dodd-Frank and SEC rules could go too far by prescribing definitions for what is an accurate rating. This will ultimately lead to a homogenization of ratings, which offers new competitors fewer reasons to enter the market and greater systemic risk
- **Elimination of NRSRO's Regulation FD exemption**. Pursuant to Section 939B of Dodd-Frank, the SEC was charged with amending Reg FD to eliminate exemptions for disclosure of material nonpublic information to NRSROs. We suspect the Big Three will claim that the loss of their Reg FD exemption due to Dodd-Frank is a reason why they were lacking information to downgrade MF Global in a timely fashion. Rapid Ratings' ability to precisely and accurately identify deterioration in MF Global with only publicly available information should counter this claim.

These and other topics are explored in greater depth in Rapid Ratings' prior testimonials to Congress and the U.S. Securities and Exchange Commission:

1. "Oversight of the Credit Rating Agencies Post Dodd-Frank." 27 July 2011, United States House of Representatives Committee on Financial Services, Subcommittee on Oversight and Investigations. Testimony. http://financialservices.house.gov/UploadedFiles/072711gellert.pdf
2. "Transforming Credit Rating Agencies." 30 September 2009, United States House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. Testimony. http://financialservices.house.gov/media/file/hearings/111/gellert_testimony_on_transforming_credit_rating_agencies_final_09302009.pdf
3. "Proposals to Enhance the Regulation of Credit Rating Agencies." 5 August 2009, United States Senate Committee on Banking, Housing and Urban Affairs. Testimony. http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=8fdc65ca-0cf8-4f65-869f-68ea727331c7
4. "Competition in the Credit Rating Industry." 15 April 2009, SEC Roundtable to Examine Oversight of Credit Rating Agencies. Presentation. http://www.sec.gov/comments/4-579/4579-20.pdf

Conclusion

MF Global's demise was a terrible development for the market, and its aftermath a tragedy. It has affected Wall Street, the entire futures industry and quite literally Main Street, leaving farmers across the country insolvent. That customer funds are still missing months after the bankruptcy filing speaks to the complexity of the problems that led to this firm's failure.

Ultimately, the story of MF Global is reasonably straightforward. A traditional and well-respected intermediary in the futures markets began to decline in its core business, and its financial health deteriorated. New management came in and began to diversify the business. In doing so, new risks were being taken with limited company capital. Instruments being traded with company capital were contrarian bets that ultimately spooked clients, regulators, shareholders and counterparty liquidity providers. These stakeholders worried about the capital base of the firm and began to require additional capital be added. All the while, the firm saw revenues deteriorating, profits turning to consecutive quarterly losses and weakening debt service management.

As a backdrop to all of this, the Big Three issuer-paid agencies, S&P, Moody's and Fitch, maintained investment grade ratings on MF Global for years. Their ratings showed very little deterioration, despite the multitude of qualitative and empirical factors that pointed to decreased health and increased risk taking at the firm. In the end, Moody's finally downgraded the firm to below investment grade, intensifying capital calls on the riskier trades. This helped precipitate the firm's final spiral and ultimate bankruptcy.

There were many qualitative factors in the MF Global story, but what stands out are the quantitative ones that Rapid Ratings' Financial Health Rating system used to provide early warnings of the firm's deteriorating financial strength: weakening Sales Performance, Profit Performance and Debt Service Management. As a user-paid, not issuer-paid, firm, we have no contact with issuers, we do not factor any management star power or story into our ratings and we rate purely based on firms' financial performance. This allows us to rate public and private companies consistently and objectively. MF Global's ratings deteriorated markedly over the past few years and our system had rated them a High Risk entity since June 2009.

Whether the Big Three didn't properly evaluate the increasing evidence (including disclosures made by the firm as far back as May 2011) or determined there actually wasn't increased risk at MF Global, they failed to give adequate warning on the brokerage's failure. Once again, the market was ill served by flatlined ratings that did not adequately reflect the risk of a company. Not only were the Big Three slow in identifying risk at MF Global, they were highly correlated in their ratings products. The similarity in their ratings further illuminates the lack of unique information value in their product.

One of the Big Three, S&P, is asserting that it only relied on public filings for information on MF Global's trading positions.[17] But this doesn't explain why it neglected to analyze the disclosure and make inquiry about the positions, their implications and on whose behalf they were made. If a hallmark of their rating methodology is qualitative analysis, where was the quality of their analysis?

The MF Global example demonstrates yet again the importance of having up-to-date ratings that are not artificially inflated or maintained. It also highlights the glaring need for greater competition in the rating industry and the need to reduce market reliance on the Big Three firms.

Accurate early warnings of companies' financial health are essential. The legislative and regulatory environment must embrace competition as a critical goal in the effort to evolve the rating industry. That means making a serious commitment to removing the barriers to new entrants including the cost of compliance for smaller rating agencies. Investment managers, risk professionals and regulators, as well as many others, deserve to have multiple opinions and analytical inputs to incorporate in their decision-making processes. Certainly those who had our early warnings on MF Global were better served than those who relied exclusively on the Big Three agencies, whose ratings provided none. We also need a commitment to quarterly ratings so that there is greater transparency and accountability in the market. These steps will help reduce the dominance of the Big Three as they continue to promise much and deliver much less.

[17] Faux, Zeke and Mattingly, Phil. "MF Global Said 'Never Been Stronger' a Week Before Failure." *Bloomberg* Jan 30 2012. http://www.bloomberg.com/news/2012-01-30/mf-global-told-s-p-it-had-never-been-stronger-one-week-before-collapse.html

Appendix A

Figure 2 below depicts the ratio net operating profit to shareholder equity, one of 23 profit ratios that demonstrate sustained deterioration and weakness in MF Global.

Figure 2: MFG's Net Operating Profit After Taxes / Shareholders' Equity Ratio: 2006-2011

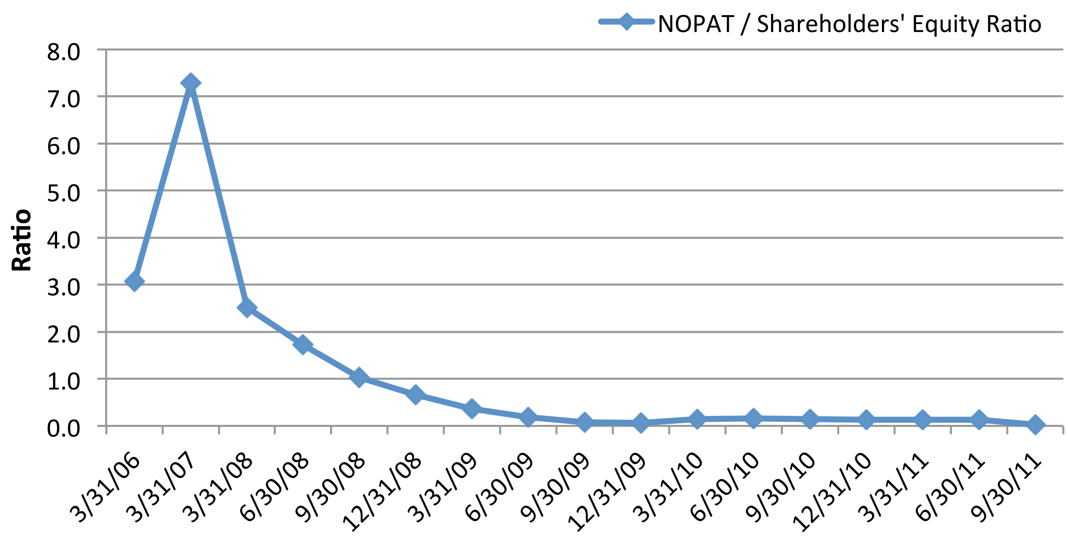
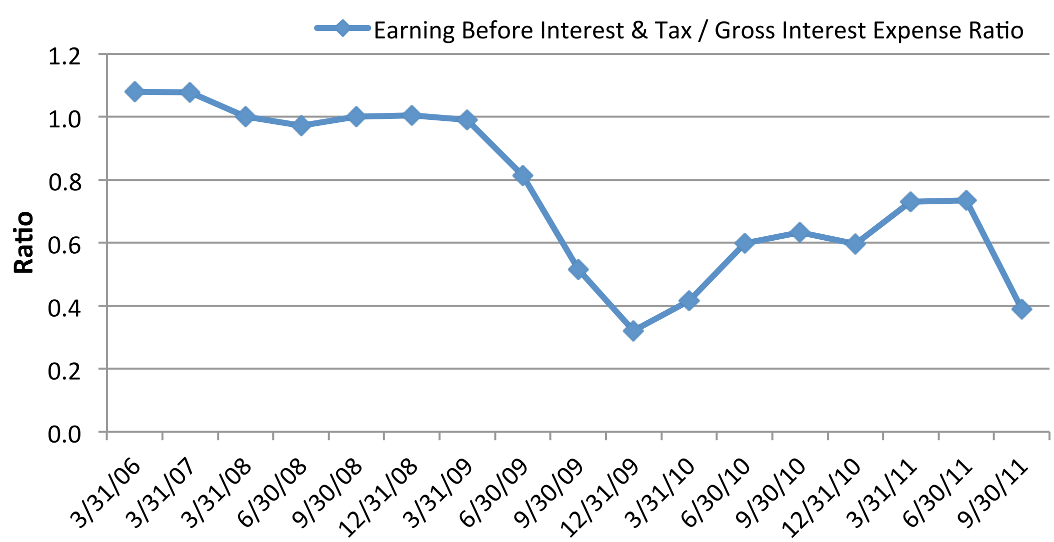


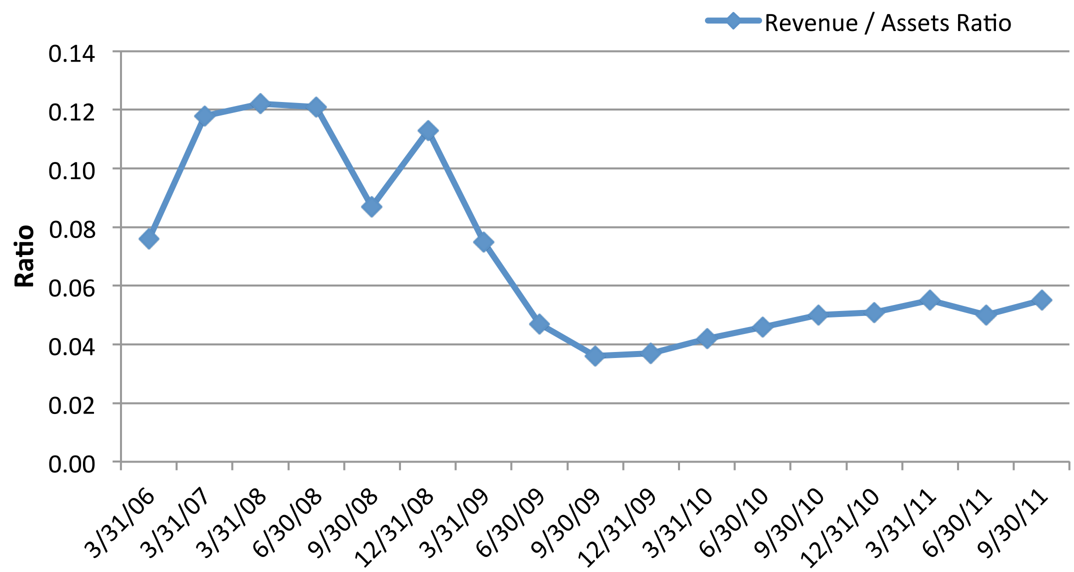
Figure 3 below presents a measure of MF Global's interest coverage ratio, one of three ratios that represent its declining Debt Service Management performance.

Figure 3: MF Global's Interest Cover Ratio: 2006-2011



An example of MF Global's deterioration in sales performance (one of five ratios) is presented in Figure 4 below.

Figure 4: MF Global's Revenue / Total Assets Ratio: 2006-2011



Appendix B

Table 1 below highlights the major events during 2007-2011 that shaped the steady decline and collapse of MF Global. Items highlighted in yellow provide a quarterly snapshot of Rapid Ratings' risk assessment of the financial health of MF Global over the course of five years. At key intervals there were major declines, and the FHR system provides reasons for those declines.

Table 1: Timeline of events leading to the collapse of MF Global (Rapid Ratings actions in yellow)

A	B	C
Date	**Event**	**Rapid Ratings Risk Assessment**
2007	Man Group sold its brokerage business, renamed MF Global, to focus on alternative investment management.[18] At that point, MF Global went public. MF Global was not a specialist in swaps, European bonds or proprietary trading, which later came to dominate its commercial activity.	FHRs from Rapid Ratings are below for each period
June 29, 2006	Rapid Ratings released a new rating for MF Global.[19] The company is not investment grade. This financial year data was issued by the new listed company, MF Global, after the Man Group divestment.	53 (12 pts below investment grade) (Medium Risk) retrospective
May 31, 2007	Both S&P (with a stable outlook) and Fitch rated MF Global as BBB+ (investment grade, three notches above junk). This was their first rating of MF Global.	53 (Medium Risk) retrospective
June 29, 2007	Rapid Ratings released a new rating for MF Global (up 7 points but still sub-investment grade).[19]	60 (Medium Risk) retrospective
July 24, 2007	Moody's issued a solid investment grade rating for MF Global (A3).	60 (Medium Risk) retrospective
Feb 28, 2008	Moody's issued a lower investment grade rating for MF Global (Baa1) – down one notch, and with a negative outlook.	60 (Medium Risk) retrospective
Feb 29, 2008	S&P rated MF Global as BBB (investment grade, two notches above junk) with a negative outlook.	60 (Medium Risk) retrospective
June 27, 2008	Moody's issued an investment grade rating for MF Global (Baa1).	60 (Medium Risk) retrospective
June 29, 2008	Rapid Ratings released a new rating for MF Global (down 11 points). *Major factors in the decline were a deteriorating profit score, which dropped by 29% over the previous quarter, and a 16% decline in sales/revenue performance.*[19]	49 (Medium Risk) retrospective

[18] "History of Man Group." Website. http://www.mangroupplc.com/assets/pdf/media/timeline.pdf
[19] Rapid Ratings first rated MF Global on January 27, 2009. The previous ratings are retrospective ratings using only data from that time period. A retrospective rating uses the financial data for the time period in question but is estimated some months or even years after the period. NO new information is used. This is a normal part of backtesting performance.

July 18, 2008	J.C. Flowers took a 6% preferred stake in MF Global three months after the firm took a $141 million charge from unauthorized wheat trading.[20, 21] On the same day, S&P removed the CreditWatch Negative designation.	49 (Medium Risk) retrospective
Aug 29, 2008	Rapid Ratings released a new rating for MF Global (down 2 points).[22]	47 (Medium Risk) retrospective
Dec 4, 2008	S&P affirmed the BBB rating but changed the outlook to negative.	42 (Medium Risk retrospective
Jan. 16, 2009	Moody's issued an investment grade rating for MF Global (Baa2, downgraded 1 notch), with a stable outlook.	42 (Medium Risk) retrospective
Jan. 27, 2009	Rapid Ratings released a new rating for MF Global (down 5 points). *There were three generic areas of deterioration. The overall profitability score declined another 12.5% over the previous quarter, sales/revenue performance declined by 26% and there was a moderate weakening in working capital efficiency (including liquidity).*	42 (Medium Risk) retrospective
Feb 25, 2009	S&P affirmed the BBB rating and reiterated its negative outlook.	42 (Medium Risk) retrospective
March 1, 2009	Rapid Ratings released a new rating for MF Global (down 1 point).	41 (Medium Risk) retrospective
April 2009	The Commodity Futures Trading Commission warned the Fed in April 2009 it had uncovered major compliance issues regarding MF Global. This problem delayed the Fed's acceptance of MF Global as a primary broker until February 2011.[23] During that interval MF Global's financial health declined further and it became a High Risk company (see column C).	41 (Medium Risk) retrospective
June 17, 2009	Fitch issued an investment grade rating for MF Global (BBB).	41 (Medium Risk) retrospective
June 29, 2009	Rapid Ratings released a new rating for MF Global (down 5 points). *There were two generic areas of deterioration. The firm's profitability score declined by 21% over the previous quarter. Sales/revenue performance dropped by 22%. MF Global became High Risk for the first time (29 rating points below investment grade) and never recovered.*	36 (High Risk)
Aug 29, 2009	Rapid Ratings released a new rating for MF Global (down another 5 points) – High Risk.	31 (High Risk)
Sep 24, 2009	S&P affirmed the BBB rating and reiterated its negative outlook.	31 (High Risk)
Nov 6,	Moody's confirmed the rating at Baa2, but lowers the outlook to negative.	31 (High Risk)

[20] Dezember, Ryan. "MF Global and Chris Flowers: A Match Made for Rescue?" *Wall Street Journal* 30 Oct 2011. http://blogs.wsj.com/deals/2011/10/30/mf-global-and-chris-flowers-a-match-made-for-rescue/
[21] *EDGAR Online – SEC Filings.* MF Global Holdings Ltd. http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHtmlSection1?SectionID=7951304-103135-117103&SessionID=HUjUFWRLX2Iin47
[22] Rapid Ratings first rated MF Global on January 27, 2009. The previous ratings are retrospective ratings using only data from that time period. A retrospective rating uses the financial data for the time period in question but is estimated some months or even years after the period. NO new information is used. This is a normal part of backtesting performance.
[23] Lynch, Sarah. "A Persistent MF Global won NY Fed dealer status." *Thompson Reuters News & Insight* 15 Dec 2011. http://newsandinsight.thomsonreuters.com/Legal/News/2011/12_-_December/A_persistent_MF_Global_won_NY_Fed_dealer_status/

2009		
Nov 29, 2009	Rapid Ratings released a new rating for MF Global (down 6 points) – High Risk. *There were three generic areas of deterioration. The profitability score declined by a further 40% and sales/revenue performance dropped by another 20%. And for the first time there was a major decline in the debt service management capability of MF Global.*	25 (High Risk)
Dec 2009	The Commodities Futures Trading Commission imposed a $10 million fine on MF Global for "significant supervision violations" arising from rogue trading. MF Global was ordered to enhance its internal controls.[24]	25 (High Risk)
March 1, 2010	Rapid Ratings released a new rating for MF Global (down 2 points) – High Risk (only 3 points above Very High Risk now).	23 (High Risk)
March 23, 2010	At the invitation of JC Flowers, a former Goldman Sachs colleague, Jon Corzine joined MF Global as CEO, and proceeded to shift its focus from assisting clients with their derivatives trading to proprietary trading on behalf of MF Global. Corzine significantly increased the risk exposure of the company because of, or in spite of, MF Global's current profitability problems.	23 (High Risk)
April 2010	The Euro-zone crisis emerged as interest rates rose dramatically on bonds issued by Greece, Portugal, and Ireland. The interest rate shocks for bonds issued by Spain and Italy followed in November 2010. In 2011, the Euro-crisis escalated significantly. Corzine saw this as a big opportunity, but the market did not agree.	23 (High Risk)
June 4, 2010	Rapid Ratings released a new rating for MF Global (up 3 points) – High Risk.	26 (High Risk)
Aug 12, 2010	Rapid Ratings released a new rating for MF Global (rose 2 points) – High Risk.	28 (High Risk)
Sept. 2010	MF Global began investing in sovereign bonds of Belgium, Italy, Ireland, Portugal and Spain.	28 (High Risk)
October 2010	The Q2 2011 financials (10Q) released by MF Global explicitly state that a reduction in its long-term credit rating would have led to repayment pressure from lenders.[25]	28 (High Risk)

[24] Lynch, Sarah. "A Persistent MF Global won NY Fed dealer status." *Thompson Reuters News & Insight* 15 Dec 2011. http://newsandinsight.thomsonreuters.com/Legal/News/2011/12_-_December/A_persistent_MF_Global_won_NY_Fed_dealer_status/

[25] "Certain of the Company's derivative trading agreements contain provisions requiring the Company to post collateral according to the Company's long-term credit ratings. These terms are pursuant to bilateral agreements with certain counterparties, and could require immediate payment or ongoing overnight collateralization on derivative instruments in net liability positions. As of September 30, 2010, the aggregate fair value of derivative agreements, with credit-risk-related contingent features that were in a **net liability position was $13,668, for which the Company has posted collateral of $19,740** in accordance with trading agreements. If the Company's long term credit rating had a one-notch or two-notch reduction, as of September 30, 2010, the amount of additional collateral that could be called by counterparties for these derivative agreements would be approximately $1,901 and $2,003, respectively. As of March 31, 2010, the aggregate fair value of derivative agreements with credit-risk-related contingent features that were in a net liability position was $23,413, for which the Company has posted collateral of $29,861 in accordance with arrangements. If the Company's long term credit rating had a one-notch or two-notch reduction as of March 31, 2010, the amount of additional collateral that could be called by counterparties for these derivative agreements would be approximately $3,162." Using short term borrowing to finance long term positions had become much riskier since the collapse of Bear Stearns and Lehman Brothers in 2008. 10Q form for the quarterly period ended September 30, 2010, MF GLOBAL HOLDINGS LTD. Compare that their statement a year earlier in the Q2 2010 filing: "Certain of the Company's derivative trading agreements contain provisions requiring the Company to post collateral according to the Company's long-term credit ratings. These terms are pursuant to bilateral agreements with certain

Nov 11, 2010	Rapid Ratings released a new rating for MF Global (up one point) – High Risk.	29 (High Risk)
Nov 24, 2010	S&P downgraded MFG to BBB-, the lowest investment grade category.	29 (High Risk)
Dec 2010	PricewaterhouseCoopers encouraged MF Global to make public its euro-sovereign bond investments. By the end of the year, MF Global had invested $1.5bn in these bonds.[26]	29 (High Risk)
Feb 2, 2011	In January, the CFTC conducted a review of MF Global's candidacy for being a Primary Broker (assessing audited financial reports and tax returns in an on-site visit). This led to a Fed memo in January 2011 stating that MF Global "demonstrated a clear ability" to meet the Fed's standards.[27] The FRBNY approved MF Global as a primary dealer on Feb 2, 2011. This placed MF Global in very exclusive company.[28] What risk vetting procedures were used by the Fed in making this decision?[29] Only Primary dealers are permitted to trade directly with the Federal Reserve Bank of New York. They have an important position in the U.S. repurchase market, conducting repos in proprietary trading and helping the Fed manage monetary policy by trading in the repurchase market. This was a huge boost to MF Global's credibility and would have helped MF Global attract more customers[30] at a time when the fundamentals strongly indicated the company was High Risk.	29 (High Risk)
Feb 3, 2011	Moody's affirmed its Baa2 rating of MFG with a negative outlook.	29 (High Risk)
Feb 9, 2011	Rapid Ratings released a new rating for MF Global (down one point) – High Risk.	28 (High Risk)

counterparties and could require immediate payment or ongoing overnight collateralization on derivative instruments in net liability positions. As of September 30, 2009, the aggregate fair value of derivative agreements with credit-risk-related contingent features that were in a **net liability position was $12,271, for which the Company has posted collateral of $3,209** in the normal course of business. If the Company's long term credit rating had a one-notch or two-notch reduction as of September 30, 2009, the amount of additional collateral that could be called by counterparties for these derivative agreements would be approximately $5,779 or $8,279, respectively." *Notice the significant increase in the level of collateral required, roughly matching the beginning of Corzine's tenure as CEO and the end of his first year as CEO. There were no similar requirements incorporated in the Q2 2008 quarterly filing. This footnote provides a quick snapshot of how quickly things changed once Corzine was running MF Global.*

[26] Lucchetti, Aaron and Steinberg, Julie. "Corzine Rebuffed Internal Warnings on Risks." *Wall Street Journal* 6 Dec 2011. http://online.wsj.com/article/SB10001424052970204083204577080723935363452.html

[27] Lynch, Sarah. "A Persistent MF Global won NY Fed dealer status." *Thompson Reuters News & Insight* 15 Dec 2011. http://newsandinsight.thomsonreuters.com/Legal/News/2011/12_-_December/A_persistent_MF_Global_won_NY_Fed_dealer_status/

[28] BNP Paribas Securities Corp.; Barclays Capital Inc.; Cantor Fitzgerald & Co.; Citigroup Global Markets Inc.; Credit Suisse Securities (USA) LLC; Daiwa Capital Markets America Inc.; Deutsche Bank Securities Inc.; Goldman, Sachs & Co.; HSBC Securities (USA) Inc.; Jefferies & Company, Inc.; J.P. Morgan Securities LLC; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Mizuho Securities USA Inc.; Morgan Stanley & Co. Incorporated; Nomura Securities International, Inc.; RBC Capital Markets, LLC; RBS Securities Inc.; SG Americas Securities UBS Securities LLC. ("Fed approves MF Global and SG Americas Securities as Primary Dealers." *RepoWatch* 2 Feb 2011. http://repowatch.org/2011/02/02/fed-approves-mf-global-and-sg-americas-securities-as-primary-dealers/)

[29] This issue was raised in December 2011 by the Chairman of the House Financial Services Oversight Sub-committee, Randy Neugebauer: "We also have concerns with the apparent lack of due diligence conducted by the Federal Reserve Bank of New York in bestowing its primary dealer designation on MF Global - even as the firm consistently lost money." http://newsandinsight.thomsonreuters.com/Legal/News/2011/12_December/A_persistent_MF_Global_won_NY_Fed_dealer_status/

[30] "Fed approves MF Global and SG Americas Securities as Primary Dealers." *RepoWatch* 2 Feb 2011. http://repowatch.org/2011/02/02/fed-approves-mf-global-and-sg-americas-securities-as-primary-dealers/

March 2011	Michael Roseman, Chief Risk Officer of MF Global, opposed Corzine's strategy to invest in the euro-sovereign bond market. The Board supported Corzine. Roseman resigned as a result.[31]	28 (High Risk)
May 23, 2011	Rapid Ratings released a new rating for MF Global (1 point higher) – High Risk.	29 (High Risk)
May 2011	PricewaterhouseCoopers signed off on its annual audit of MF Global. It was paid $12 million for this service.[32] MF Global publicly revealed that it had $6.3bn invested in sovereign bonds from Belgium, Italy, Ireland Portugal and Spain. This prompted FINRA in June to require MF Global (MF Global's US subsidiary) to increase its capital reserves.[33] FINRA had questioned MF Global's use of Generally Accepted Accounting Principles (GAAP) to justify reporting its euro-sovereign bond exposure off balance sheet.[34]	29 (High Risk)
July 2011	The MF Global share price began a precipitous 4-month decline. Street talk in the equity market about MF Global risks preceded Big 3 rating agency downgrades to junk by almost 4 months. 	29 (High Risk)
Aug 8 2011	Rapid Ratings released a new rating for MF Global (unchanged).	29 (High Risk)
Aug-Oct 2011	According to Reuters, MF Global's segregated accounts (client money) "...shrank by $1.5 billion in August alone, government data showed. Another $1.8 billion fled over the following two months, according to preliminary estimates. In total, customers pulled out more than a third of their accounts in the three months leading up to MF Global's downfall, much of that in the frenzied final days, traders reckon. For instance, privately held Koch Industries -- whose businesses make it a leading commodities trader -- sent	29 (High Risk)

[31] Scott, Joelle. "Roseman and Woodford: The Foreboding Michaels of MF Global and Olympus." *Forbes* 7 Dec 2011. http://www.forbes.com/sites/corporateresolutions/2011/12/07/roseman-and-woodford-the-foreboding-michaels-of-mf-global-and-olympus/

[32] McKena, Francine. "MF Global: 99 Problems And Auditor PwC Warned About None." *Forbes* 2 Nov 2011. http://www.forbes.com/sites/francinemckenna/2011/10/31/mf-global-99-problems-and-auditor-pwc-warned-about-none/

[33] "MF Global's Big Bet…And Its Collapse." *New York Times Dealbook* 12 Dec 2011. Graphic. http://graphics8.nytimes.com/images/2011/12/12/business/dealbook/12global-graphic2/12global-graphic2-custom2.jpg

[34] Dunkley, Jamie. "US Regulators have been monitoring MF Global for months." *Telegraph* 2 Nov 2011. http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8865899/US-regulators-have-been-monitoring-MF-Global-for-months.html

	a letter to trading partners on October 3 saying it was switching eight accounts from MF Global to Mizuho Securities USA."[35]	
Sept 30, 2011	At the end of September 2011, MF Global had a net long exposure of $6.3bn in BIIPS sovereign bonds (Belgium, Italy, Ireland, Portugal and Spain). Their average weighted maturity was December 2012, which was within the period of coverage by the European Financial Stability Facility that expires in June 2013. One of the wrinkles was that MF Global had entered into a swap arrangement financed to maturity (repo-to-maturity). Short-term loans were underpinning these long-term bond investments, and bonds were used as collateral by MF Global for the short-term loans.	29 (High Risk)
Oct 24, 2011	Moody's downgraded MF Global to Baa3, the lowest investment grade level. S&P downgrades MF Global to BBB-, the lowest investment grade level.	29 (High Risk)
Oct 24-28, 2011	Counterparties were pressuring MF Global to post more collateral on derivatives trades and likely started reducing the company's repo financing lines.[36]	29 (High Risk)
Oct 25, 2011	MF Global announced its biggest quarterly loss ($191.6 million for the previous quarter) since it went public in 2007.	29 (High Risk)
Oct 26, 2011	S&P changed the rating from BBB- with a stable outlook to BBB- with a negative outlook.	29 (High Risk)
Oct 27, 2011 Oct 27, 2011	Fitch Ratings downgraded the ratings of MF Global Holdings Ltd. to BB+/B from BBB/F2. The reasons it gave are instructive: "Today's rating actions reflect MF's continued challenges in establishing a sustainable level of profitability and improving its leverage profile...In addition, the firm's increase in principal and, to a lesser extent, proprietary trading activities has elevated the firm's traditional risk profile. These increased risk-taking activities have resulted in sizeable concentrated positions relative to the firm's capital base, leaving MF vulnerable to potential credit deterioration and/or significant margin calls. While Fitch notes that the firm has made some progress in rationalizing its capital structure, the firm's persistently weak earnings and leverage are no longer consistent with an investment grade financial institution."[37] *Comment by Rapid Ratings: Our models indicate that MF Global's profitability problem had started in 2008 and it showed persistent losses and deterioration since then. MF Global's ability to service its debt dropped into the High Risk zone in 2010 and stayed there.* Moody's downgraded MF Global to junk (Ba2), with the following comments: "The tactical decision to assume this outsized proprietary	29 (High Risk)

[35] Prezioso, Jeanine. "Insight: Clients who fled MF Global face clawback risk." *Reuters* 11 Nov 2011. http://www.reuters.com/article/2011/11/11/us-mfglobal-clawback-f-idUSTRE7AA38A20111111
[36] Cohan, William. "MF Signs Death Warrant for Short-Term Funding." *Businessweek* 15 Nov 2011. http://www.businessweek.com/news/2011-11-15/mf-signs-death-warrant-for-short-term-funding-william-d-cohan.html
[37] Gongloff, Mark. "MF Global Falls Again After Fitch Downgrade to Junk." *Wall Street Journal* 27 Oct 2011. http://blogs.wsj.com/marketbeat/2011/10/27/mf-global-falls-again-after-fitch-downgrade-to-junk/

	position highlights the core profitability challenges faced by MF Global, and the scope of the re-engineering challenge facing the firm's management"[38] *Comment by Rapid Ratings: The profitability problem was an old one not a new one, while the large proprietary risky positions began in March 2010 after* Mr. *Corzine came aboard.*	
Oct 29-30, 2011	The Commodity Futures Trading Commission and Interactive Brokers (Connecticut) raised questions about MF Global's capital adequacy and the location of about $1 billion in client funds. This led to Interactive Brokers aborting a potential deal to purchase MF Global.[39] According to Bloomberg, CME noticed a shortfall in MF Global's segregated client funds on Oct 31 but delayed telling the Commodity Futures Trading Commission, the CME Group's regulator, until the next day.[40]	29 (High Risk)
October 31, 2011	MF Global filed for bankruptcy.[41] The largest creditors were JPMorgan Chase ($1.2 billion, but it was syndicated) and Deutsche Bank ($325 million). Moody's downgraded MF Global to Caa1 (High Risk). Fitch and S&P downgraded MF Global to D (default). MF Global (COO Abelow) in its bankruptcy court filing blamed regulators (Commodity Futures Trading Commission, the Securities and Exchange Commission and the Financial Industry Regulatory Authority). FINRA in particular raised concerns about MF Global's US broker-dealer's need for much more capital and raised its concerns about MF Global's $6.3 billion stake in short-term debt from European sovereign bonds. This led to margin calls, downgrades and collapse, said MF Global.[42]	29 (High Risk)
Nov 1, 2011	Rapid Ratings downgraded MF Global further based on newly released financials from the previous quarter. The company continued to be High Risk through to its bankruptcy.	23 (close to Very High Risk)
Nov 4, 2011	Mr. Corzine announced his resignation from MF Global as CEO and indicated he would not seek severance payments.	
Dec 13, 2011	Mr. Corzine's testimony to the Senate Agriculture Committee: "I never gave any instructions to misuse customer money, never intended to give any instructions or authority to misuse customer funds, and I find it very hard to understand how anyone could misconstrue what I've said as a way to misuse customer money."[43] No evidence to the contrary has surfaced.	

[38] "Ahead of the Bell: Moody's Downgrades MF Global" *Businessweek* 28 Oct 2011. http://www.businessweek.com/ap/financialnews/D9QLA5PO0.htm

[39] Protess, Ben. "Regulators Investigating MF Global" *New York Times* 31 Oct 2011. http://dealbook.nytimes.com/2011/10/31/regulators-investigating-mf-global/

[40] Leising, Matthew. "CME May Face 'Liability' In MF Global Disclosure, Goldman's Harris Says." *Bloomberg* 17 Nov 2011. http://www.bloomberg.com/news/2011-11-17/cme-may-face-liability-related-to-mf-global-disclosure-goldman-sachs-says.html

[41] US broker-dealers are not protected by Chapter 11 whereby regulatory shelter from creditors is providers. Broker-dealers only have two choices in the event of severe distress: (1) liquidate all assets, or (2) takeover by another firm.

[42] Spicer, Jonathan. "MF Global collapses under euro zone bets." *MSN Money* 31 October 2011. http://money.msn.com/business-news/article.aspx?feed=OBR&date=20111031&id=14453289

[43] "USA Exchanges: CME boss seems to rebut Corzine over funds." *Economist Intelligence Unit* 14 Dec 2011. http://www.eiu.com/index.asp?layout=ib3Article&article_id=198667204&country_id=1530000153&pubtypeid=1132462498&industry_id=640001064&category_id=&rf=0

Dec 14, 2011	Jill Sommers, the leader of the CFTC review of MF Global's collapse, revealed that her team knows where the missing money went, adding, "Now it's just [a question of] finding out which ones of those transactions are legitimate and which ones of them are illegitimate."[44]	
Dec 15, 2011	Moody's withdrew its rating for MF Global.	

[44] Doering, Christopher. "Exclusive: Regulators know where MF Global funds went." *Reuters* 14 Dec 2011. http://www.reuters.com/article/2011/12/14/us-mfglobal-cftc-idUSTRE7BD20L20111214

