

MEMORANDUM FOR THE RECORD

Event: Interview of two former Moody's Derivatives Staff: Mark Froeba and Gene Phillips

Type of Event: Group Interview

Date of Event: April 23, 2010, 4:15 p.m.

Team Leader: Brad Bondi

Location: PF2 Company at 48 Wall Street, Suite 100, New York, NY, 10005; 212-918-4943

Participants - Non-Commission:

- Mark Froeba, principal of PF2.
- Gene Phillips, principal of PF2

Participants - Commission:

- Brad Bondi
- Ryan Bubb
- Tom Borgers

MFR Prepared by: Tom Borgers

Date of MFR: April 27, 2010

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted except where clearly indicated as such.

Summary of the Interview or Submission:

Deputy General Counsel Brad Bondi, Senior Researcher Ryan Bubb, and Senior Investigator Tom Borgers interviewed Mr. March Froeba and Mr. Gene Phillips, principals of PF2.

Froeba has his JD from Harvard University. From 1990 to 1997, Froeba was a tax attorney for Skadden Arps with a focus on structured finance transactions. From 1997 to 2007, Froeba was a Senior Vice President and CLO team leader in Moody's Derivatives Group. His main focus was legal analysis. He also mentioned that prior to the spinoff of Moody's from D&B, his compensation was [REDACTED]. After the spinoff, all salaries at Moody's went up significantly, including his: [REDACTED].

Phillips' has both a bachelor of science and advanced degrees in mathematics. His prior work history included Citigroup in the Fixed Income Alternatives division. Phillips also worked in the Moody's Derivatives Group as a surveillance associate.

In the early years, Froeba said that there were no clear reporting lines in his area. Senior people in his area were:

- Dan Curry, Group Managing Director (MBA)
- Jerry Gluck, Managing Director (PhD)
- Eileen Murphy, Managing Director
- Gus Harris, Managing Director (MBA and CPA)
- Isaac Efrat, Managing Director. 36CFR1256.56: Privacy

Brian Clarkson

Brian Clarkson, with the support of CEO John Rutherford, positioned himself to take over the Derivative Group to increase market share. 36CFR1256.56: Privacy

After the spinoff in 2000 and the increase in subprime deals, Clarkson wanted to grow Moody's market share from 15% to 95%. He succeeded "virtually overnight" by getting rid of (through firings or transfers) all of the people who did not share his business growth model of giving the issuers what they wanted and eliminating the high rating standards of the past. Those who "played on the Clarkson team" were rewarded with high compensation—even a managing director might make \$1 million.

Until 2000, Moody's was a leader in quality ratings, and this was deeply rooted in its culture. Clarkson fired or demoted at least 22 people in the Structured Finance Group during this time period to achieve his goals—he would brag about the firings to instill fear in the staff. ¹ 36CFR

36CFR Clarkson's staff also became "yes men" because they wanted to keep their job and income.

Another example of the shift in standards and the alleged conflicts of interest was Clarkson's placing the issuers' demands ahead of those of the investors. Clarkson and others made concerted effort to find out why issuers disliked Moody's and to determine what the issuers wanted. 36CFR1256.56: Privacy

36CFR Around 2000, Gus Harris was able to get 20 issuers (deals) back because of Moody's changes to its business model for bankers.

Clarkson had a "disturbing personality" and "loved to torture people." His management skills appeared to be based on the "One Minute Manager" books that you might find in the airport and did not seem to be founded on sound professional management skills. One of Clarkson's ideas to motivate his staff involved finding a cheap place to have kid games for the staff to build interpersonal skills. Most employees did not see the benefit of this exercise.

¹ Aaron Lucchetti, "As Housing Boomed, Moody's Opened Up," *Wall Street Journal*, April 11, 2008.

While Brian Clarkson was positioning himself for promotion in August 2007, Yuri Yoshizawa was pushing to be the head of CDO Global. She did not have the professional background for this position, especially to understand the risks of synthetic CDOs.

Clarkson has been able to escape a major level of scrutiny. But all roads lead back to him.

Reverse Engineering Competitors

After 2000, as Moody's made the change from its high rating standards to the lower standards of S&P and Fitch, they tried to reverse engineer their competitors' rating models. To develop similar ratings, Moody's did not have to exactly replicate S&P's model; it just had to change its assumptions to come up with the desired rating. Froeba believes that there was a reverse engineering section at Moody's, but he does not have any names nor does he know where it was organized. Just before 2000, Moody's had one unsolicited rating, to which it pled guilty in an antitrust case.

CDO Model

The CDO model was easy to replicate, but the diversity score for corporate credit (ABS CDO) was complicated. As managers added assets, they must focus on keeping the diversity as high as possible; adding unusual assets that are not correlated was the most important criteria. For RMBS CDOs the diversity had to be 10 to 14%; if it fell below 10%, it was unreliable.

By changing the correlated assumptions, Moody's could change the rating without difficulty. Gary Witt, Gus Harris, Eva Foo, Noel Kirnon and Sergey Perkarsky were part of the committee that decided on the assumptions. "Moody's had to rate the deal appropriately or die."

S&P used a small sampling and Fitch was definitely a bottom fisher. There were no concerns about being accurate in the ratings. Rating agencies had no legal liability.

Moody's London CLO – Rating of Corporate Loans

In 2006, the developers of the London CLO model for rating individual corporate loans were knowingly using a faulty model for their rating of individual loans to increase market share. London refused to recognize model problems and make the necessary corrections. In 2006, the New York Moody's team, including Froeba, told management about this problem many times but nothing was corrected for many months. The net effect of their inflated ratings would have been between one and two notches in the ratings.

In New York everyone knew the model was BS. Froeba had spelled out all of the problems with the London model in a long email, but Moody's was not going to go back and fix it. (Froeba believed that the email was in the fall of 2007.) Froeba believes that this could be a fraud case.

Because of this problem, some analysts were shown the door:

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Recommendation of Froeba and Phillips

They recommended that the FCIC request the BES Survey to get a better understanding of Clarkson and his senior staff. They also suggested focusing on three individuals and how they directed the company:

- John Rutherford – The creator of the new business model of market share at any cost, including the elimination of the high standards and culture at Moody’s.
- Raymond Mc Daniel – He took Rutherford business model to the next level and supported Clarkson’s approach.
- Warren Buffet (major shareholder)

Other people to interview:

- Tad Phillips – Good guy to interview.
- Bill May – [REDACTED]
- Mark Adelson – RMBS person. [REDACTED]
- Rich Michalek – He is one of the best witnesses. Phillips recommends that we review the 20 pages written testimony for PSI; he believes that it has a wealth of information.
- Isaac Efrat – Managing Director. [REDACTED]
[REDACTED] Efrat is a Senior Managing Director with Aladdin Capital Holdings, Inc in Stamford, CT.
- Sergey Perkarsky – He works at Greywolf Capital Management located in Purchase, New York. His number is [REDACTED] He was one of the assumption committee members.
- Jennifer Zhao – [REDACTED]
[REDACTED]
- Gary Witt – He could help us with the Assumption Committee and other areas of our investigation.

For all of the people fired, we should ask for the personnel files, including the early 22 mentioned in the news article above. That should give us answers about Moody’s they wanted to control the rating with a staff of “yes” men, who were afraid for their jobs and liked the high compensation. Froeba also mentioned that the FCIC should look at his and Adelson’s testimony before the Senate Banking Committee in 2009. Froeba and Phillips believe that those hearings were pretty useless.

Froeba believes that the ratings agencies could have stopped the crisis by refusing to rate subprime deals and making a more clear separation between the business and the rating areas.

Froeba and Phillips said that PF2 could do a comparison of the models: new vs. the old. They will get back to FCIC about this.