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# **2011 SUMMARY REPORT OF COMMISSION STAFF'S EXAMINATIONS OF EACH NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION**

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As Required by Section 15E(p)(3)(C)  
of the Securities Exchange Act of 1934



**This is a report of the Staff of the U.S. Securities and Exchange Commission.**

**The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.**

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**September 2011**

## I. SUMMARY

This Report summarizes the examinations conducted by staff from the U.S. Securities and Exchange Commission (the “Staff”) under Section 15E(p)(3) of the Securities Exchange Act of 1934 (“Exchange Act”).<sup>1</sup> This is a report of the Staff and, as such, reflects solely the Staff’s views. The U.S. Securities and Exchange Commission (“Commission”) is making this Staff report public as required by Section 15E(p)(3)(C) of the Exchange Act.

## II. BACKGROUND

### A. Statutory Framework and Rules

In 2006, Congress passed the Credit Rating Agency Reform Act (the “Rating Agency Reform Act”) that provided the Commission with the authority to establish a registration and oversight program for credit rating agencies.<sup>2</sup> The Rating Agency Reform Act added Section 15E to the Exchange Act, which established Commission oversight over those credit rating agencies that register with the Commission as Nationally Recognized Statistical Rating Organizations (“NRSROs”). The Rating Agency Reform Act also amended Section 17 of the Exchange Act to provide the Commission with recordkeeping, reporting, and examination authority over registered NRSROs.<sup>3</sup>

Importantly, Section 15E(c)(2) expressly prohibits the Commission from regulating the substance of credit ratings or the procedures and methodologies by which an NRSRO determines credit ratings.

In 2007, the Commission adopted Exchange Act Rules 17g-1 through 17g-6 and Form NRSRO to implement the registration and oversight program required by the Rating Agency Reform Act. Pursuant to these rules, registered NRSROs must, among other things, make certain public disclosures, make and retain certain records, furnish financial reports to the Commission, establish and enforce procedures to manage the handling of material non-public information, and disclose and manage conflicts of interest. The Commission’s rules also prohibit an NRSRO from having certain conflicts of interest and engaging in certain unfair, abusive, or otherwise coercive practices. The Commission amended several of these rules in February 2009 and December 2009 with the goal of further increasing the transparency of NRSRO rating methodologies, strengthening the disclosures of rating performance, prohibiting NRSROs from engaging in certain practices, and enhancing NRSRO record keeping.

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<sup>1</sup> 15 U.S.C. § 78o-7(p)(3)(C). Unless otherwise noted, all Section and Rule references in this Report are to the Securities Exchange Act of 1934 and related rules. *See* 15 U.S.C. § 78o-7; 15 U.S.C. § 78q (a) & (b); 17 C.F.R. § 240.17g.

<sup>2</sup> Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006)

<sup>3</sup> *See* Section 17(a).

In July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which, among other things, amended Section 15E to enhance the regulation and oversight of NRSROs by imposing new reporting, disclosure, and examination requirements.<sup>4</sup> The Dodd-Frank Act directs the Commission to adopt rules to implement a number of provisions related to NRSROs. To this end, the Commission adopted new Rule 17g-7 and has proposed new rules to implement certain provisions of the Dodd-Frank Act concerning the following areas:

- Filing annual reports on internal controls;<sup>5</sup>
- Addressing conflicts of interest with respect to sales and marketing concerns;<sup>6</sup>
- Conducting “look back” reviews of ratings in which former NRSRO employees participated to determine whether employment opportunities with a rated entity, issuer, underwriter, or sponsor influenced the rating;<sup>7</sup>
- Disclosing information relating to initial credit ratings and subsequent changes to credit ratings to track the performance of an NRSRO’s credit ratings;<sup>8</sup>
- Requiring an NRSRO to have certain policies and procedures governing the way an NRSRO determines credit ratings;<sup>9</sup>
- Publishing a standard form with each credit rating disclosing the assumptions underlying the methodology used to determine the credit rating;<sup>10</sup>
- Disclosing information concerning third-party due diligence reports for asset-backed securities;<sup>11</sup>
- Establishing professional standards for training credit rating analysts;<sup>12</sup> and
- Requiring the consistent application of rating symbols and definitions.<sup>13</sup>

As of the date of this Report, the Commission has adopted the following rules applicable to NRSROs:

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<sup>4</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (“Dodd-Frank”), § 932, 124 Stat. 1376, 1872-83 (2010).

<sup>5</sup> Section 15E(c)(3)(B).

<sup>6</sup> Section 15E(h)(3)(A).

<sup>7</sup> Section 15E(h)(4)(A).

<sup>8</sup> Section 15E(q)(1).

<sup>9</sup> Section 15E(r).

<sup>10</sup> Section 15E(s)(1).

<sup>11</sup> Section 15E(s)(4)(C).

<sup>12</sup> Dodd-Frank, § 936, 124 Stat. 1884-85.

<sup>13</sup> Dodd-Frank, § 938(a), 124 Stat. 1376, 1885.

<b>Exchange Act Rules Applicable to NRSROs</b>	
Rule 17g-1	Requires an NRSRO to apply for NRSRO status and issue credit ratings for various classes of securities by filing a Form NRSRO with the Commission, and prescribes how an NRSRO must keep its registration up-to-date and file an annual certification. Additionally, an NRSRO must make its current Form NRSRO and information and documents submitted in Exhibits 1 through 9 to Form NRSRO publicly available.
Rule 17g-2	Requires an NRSRO to make and retain certain types of business records and publicly disclose certain ratings history data.
Rule 17g-3	Requires an NRSRO to file annual financial reports and reports of the number of credit rating actions with the Commission, some of which are audited.
Rule 17g-4	Requires an NRSRO to establish and enforce written policies and procedures designed to address specific areas in which material, nonpublic information could be inappropriately disclosed or used.
Rule 17g-5	Identifies a series of conflicts of interest arising from the business of determining credit ratings. Some of these conflicts must be disclosed and managed, while others are expressly prohibited.
Rule 17g-6	Prohibits NRSROs from engaging in certain unfair, abusive, or coercive practices.
Rule 17g-7	Requires NRSROs to include information regarding the representations, warranties, and enforcement mechanisms available to investors in an asset-backed securities offering in any report accompanying a credit rating issued in connection with such offering, including a preliminary credit rating, as well as how those representations, warranties, and enforcement mechanisms differ from those in similar offerings.

B. Annual Examinations

Generally, the purpose of NRSRO examinations is to facilitate compliance with applicable laws and rules, identify potential violations of such laws and rules, and monitor for remedial action. Examinations also serve to inform the Commission and Commission staff of NRSROs' compliance with their regulatory obligations and noteworthy industry developments. If the examination staff identifies potential violations of federal securities laws or rules during an NRSRO examination, the staff may refer the matter to the Commission's Division of Enforcement, which is responsible for further investigating these potential violations and taking further action when appropriate, either in a Federal court or in an administrative action.

Section 15E(p)(3)(A), added by the Dodd-Frank Act, requires the Staff to conduct an examination of each NRSRO at least annually. Under Section 15E(p)(3)(B), each examination must include a review of the following:

1. Whether the NRSRO conducts business in accordance with its policies, procedures, and rating methodologies;
2. The management of conflicts of interest by the NRSRO;
3. Implementation of ethics policies by the NRSRO;
4. The internal supervisory controls of the NRSRO;
5. The governance of the NRSRO;
6. The activities of the designated compliance officer of the NRSRO;
7. The processing of complaints by the NRSRO; and
8. The NRSRO's policies governing the post-employment activities of former staff of the NRSRO.<sup>14</sup>

C. Requirement for a Summary Staff Report

Section 15E(p)(3)(C) requires that the Commission make available to the public, in an easily understandable format, an annual report summarizing (i) the essential findings of the Section 15E examinations as deemed appropriate by the Commission; (ii) the responses by the NRSROs to any material regulatory deficiencies identified by the Commission in those findings; and (iii) whether the NRSROs have appropriately addressed the recommendations of the Commission contained in previous Section 15E summary reports.<sup>15</sup>

D. Registered NRSROs

In 2007, following the adoption of the Commission's first set of NRSRO rules, the Commission began granting registrations to credit rating agencies that applied to be registered as an NRSRO. A credit rating agency may apply to be registered with respect to one or more of the following five classes of credit ratings: (1) financial institutions, brokers, or dealers ("financial institutions"); (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities ("asset-backed securities"); and (5) issuers of government securities, municipal securities, or securities issued by a foreign government ("government securities"). To date, the Commission has granted NRSRO registration to ten credit rating agencies. Those credit rating agencies and dates of registration are listed below:

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<sup>14</sup> Section 15E(p)(3)(B)(i)-(viii).

<sup>15</sup> Section 15E(p)(3)(C)(i)-(iii).

<b>NRSRO</b> <sup>16</sup>	<b>Date of Registration</b>
A.M. Best Company, Inc. (“A.M. Best”)	September 24, 2007
DBRS Inc. (“DBRS”)	September 24, 2007
Egan-Jones Rating Company (“Egan-Jones”)	December 21, 2007
Fitch, Inc. (“Fitch”)	September 24, 2007
Japan Credit Rating Agency, Ltd. (“JCR”)	September 24, 2007
Kroll Bond Rating Agency (“Kroll”) <sup>17</sup>	February 11, 2008
Moody’s Investors Service, Inc. (“Moody’s”)	September 24, 2007
Morningstar Credit Ratings, LLC (“Morningstar”) <sup>18</sup>	June 23, 2008
Rating and Investment Information, Inc. (“R&I”)	September 24, 2007
Standard & Poor's Ratings Services (“S&P”)	September 24, 2007

The table and charts below list the number of outstanding ratings reported by each NRSRO in its Form NRSRO annual certification for 2010. For each NRSRO, the table sets forth the number of outstanding ratings for the five asset classes.

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<sup>16</sup> Orders granting registration can be found at: <http://www.sec.gov/divisions/marketreg/ratingagency.htm>. In addition, each NRSRO is required to post its Form NRSRO on its own website.

<sup>17</sup> Kroll was formerly LACE Financial Corp.

<sup>18</sup> Morningstar was formerly Realpoint LLC.

<b>NRSRO Ratings Outstanding by Asset Class*</b>						
	Financial Institutions	Insurance Companies	Corporate Issuers	Asset-Backed Securities	Government Securities	Total
A.M. Best	N/R	5,062	2,043	54	N/R	<b>7,159</b>
DBRS	14,941	156	3,863	10,091	13,533	<b>42,584</b>
Egan-Jones	89	47	877	13	19	<b>1,045</b>
Fitch	61,550	1,657	13,385	64,535	363,897	<b>505,024</b>
JCR	159	30	495	N/R**	52	<b>736</b>
Kroll	16,515	48	1,002	0***	59	<b>17,624</b>
Moody's	61,581	4,540	30,285	101,546	841,235	<b>1,039,187</b>
Morningstar	N/R	N/R	N/R	8,322	N/R	<b>8,322</b>
R&I	503	48	2,836	N/R	1,031	<b>4,418</b>
S&P	54,000	8,200	44,500	117,900	965,900	<b>1,190,500</b>
<b>Total</b>	<b>209,338</b>	<b>19,788</b>	<b>99,286</b>	<b>302,461</b>	<b>2,185,726</b>	<b>2,816,599</b>

\* As reported by the NRSROs on Form NRSRO, dated as of year-end 2010.

\*\* N/R" indicates the NRSRO is not registered for that class of securities. R&I and JCR withdrew from their NRSRO registrations in asset-backed securities on June 28, 2010 and December 2, 2010, respectively.

\*\*\*Kroll is registered in asset-backed securities, although it reported no ratings in this class as of year-end 2010.

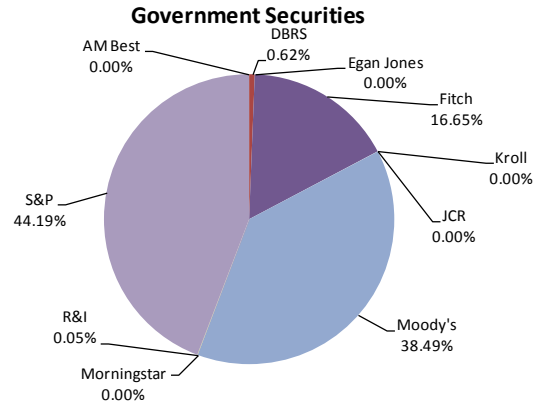
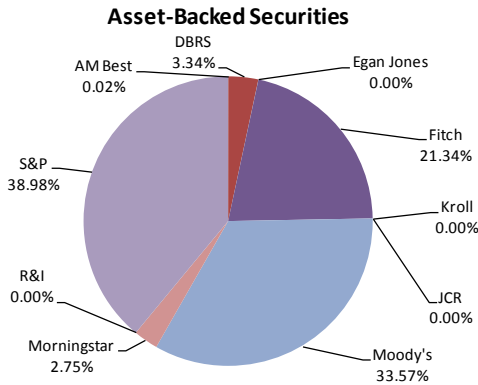
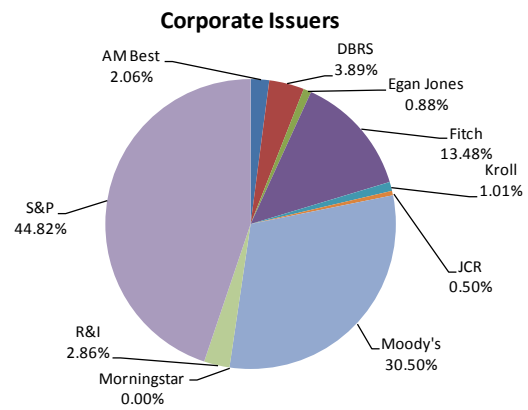
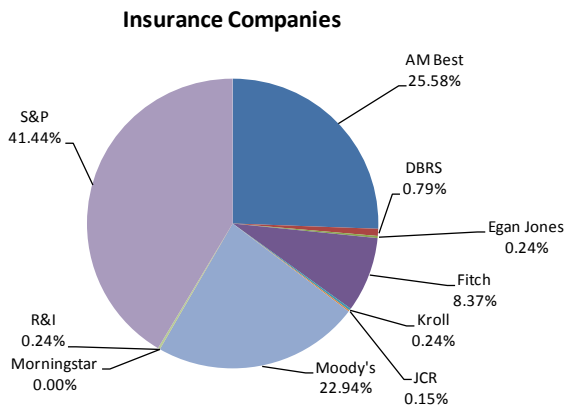
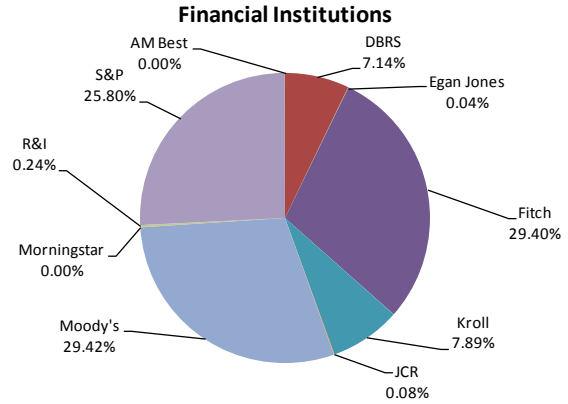
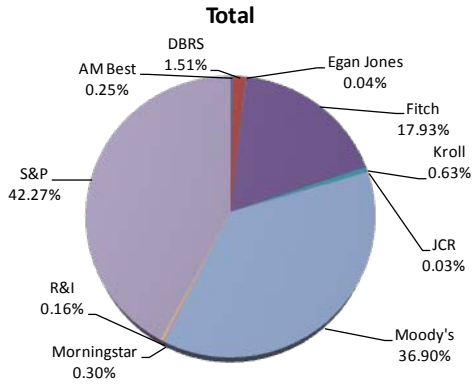
Moody's and S&P are the two largest registered NRSROs based on number of ratings reported outstanding, with approximately 1 million and 1.2 million ratings reported outstanding, respectively. Fitch is the third largest with approximately 500,000 ratings reported outstanding.

Generally, the agencies vary in their focus on credit ratings for particular asset classes. Some agencies specialize in a particular class. Moody's and S&P report issuing the greatest number of credit ratings for corporate issuers, asset-backed securities, and government securities. For credit ratings related to financial institutions, Fitch and Moody's report issuing more ratings than S&P. S&P reports issuing the most ratings for insurance companies, with A.M. Best, Moody's, and Fitch reporting issuance of most of the remaining ratings in that asset class. Some of the smaller NRSROs concentrate more on particular sectors or regions. For example, A.M. Best primarily assigns insurance financial strength ratings while Morningstar specializes in asset-backed securities. Prior to its acquisition by Kroll, LACE Financial Corp. primarily focused on ratings of financial institutions. Two NRSROs, JCR and R&I, are based in Japan and primarily issue ratings on Japanese companies.

The charts below illustrate the differences in reported coverage between the ten agencies in each of the five ratings sectors.<sup>19</sup>

<sup>19</sup> The charts represent the percentage of total outstanding ratings of all NRSROs combined, as reported on Form NRSRO, and not a percentage of the total number of rated obligors, issuers, and issues/obligations.

# Credit Ratings Outstanding





The table below illustrates the relative size of each NRSRO in terms of staffing:

<b>Number of Credit Analysts and Credit Analyst Supervisors*</b>			
	Credit Analysts	Credit Analyst Supervisors	Total
A.M. Best	77	43	120
DBRS	75	20	95
Egan-Jones	2	3	5
Fitch	712	337	1,049
JCR	27	30	57
Kroll	9	4	13
Moody's	1,088	116	1,204
Morningstar	17	7	24
R&I	74	4	78
S&P	1,109	236	1,345

\* As reported by each NRSRO on Exhibit 8 of Form NRSRO, for year-end 2010.

#### E. The Staff's Examinations

Section 15E(p)(1) requires that the Commission establish an Office of Credit Ratings to administer the rules of the Commission adopted under Section 15E, and requires that this office conduct the annual Section 15E examinations. Section 15E(p)(2) provides that the office will be sufficiently staffed to carry out its duties.

To establish this office, the Commission requires the reprogramming approval of both the House and Senate Appropriations Subcommittees on Financial Services and General Government. The Commission has not received the Congressional approval necessary to establish the office. Nevertheless, recognizing the importance of the Section 15E examination requirement, the NRSRO examination staff from the Commission's Office of Compliance Inspections and Examinations ("OCIE") conducted these examinations along with examiners from other OCIE program areas and NRSRO specialists from the Commission's Division of Trading and Markets. Because of the limited resources available for these examinations, the Staff focused on covering the review areas mandated by Section 15E(p)(3)(B) for this year's examinations and enhancing its expertise in these areas as they relate to each NRSRO's operations for further risk assessment and scoping of future examinations.

The Staff began its first set of Section 15E examinations in August 2010, shortly after passage of the Dodd-Frank Act. The examinations generally focused on NRSRO activities for the period covering December 1, 2009 through August 1, 2010 (the "Review Period").<sup>20</sup>

<sup>20</sup> This Review Period allowed the Staff to review each NRSRO's activities during the several months before the examinations began.

### III. SUMMARY OF ESSENTIAL FINDINGS

The following summarizes the essential findings of the Staff's Section 15E examinations. For purposes of this Report, "essential findings" includes the Staff's notable observations and concerns arising from the examinations. These "essential findings" are not findings of the Commission, and the Staff's expression of concern about an issue does not necessarily mean that the Commission or the Staff has reached a definitive conclusion about that issue.

As of the date of this Report, the Commission has not determined that any finding discussed in this Report constitutes a "material regulatory deficiency," but may do so in the future. If the Commission determines that any finding of a Section 15E examination does constitute a "material regulatory deficiency," the Staff will include the relevant NRSRO's response to such deficiency in a future summary report.

Beginning with next year's summary report, the Staff will include a summary of whether the NRSROs have appropriately addressed recommendations contained in previous reports. The Staff notes that, in some cases, the NRSROs have already taken steps to address concerns that the Staff raised during the examination process.

For purposes of this Report, the Staff has divided the NRSROs into two groups: the three "larger" NRSROs—Fitch, Moody's and S&P—and the remaining seven "smaller" NRSROs—A.M. Best, DBRS, EJR, JCR, Kroll, Morningstar, and R&I.

#### A. General Observations

The Staff makes the following general observations:

1. The NRSROs appear to be trending even more toward employing the issuer-pay business model.

Of the ten registered NRSROs, seven—including the three larger NRSROs—operate predominantly under the issuer-pay model.<sup>21</sup> The remaining three have historically operated predominantly under the subscriber-pay model. However, two of the subscriber-pay NRSROs have recently taken steps to focus more on issuer-pay business. This new focus on the issuer-pay model appears to be occurring with respect to ratings of asset-backed securities.

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<sup>21</sup> There are two business models used by the NRSROs. Under the issuer-pay model, the NRSRO receives compensation from obligors for rating the obligor or securities issued by the obligor. Under the subscriber-pay model, subscribers pay the NRSRO for access to the NRSRO's ratings.

2. The NRSROs have been subject to substantial, relatively new legal and regulatory requirements.

As discussed above, the current regulatory structure of NRSROs began with the Rating Agency Reform Act in 2006, followed by Commission rulemaking pursuant to the Rating Agency Reform Act in 2007 and 2009, and the passage of the Dodd-Frank Act in 2010. Since the end of the Review Period, the Commission has adopted one new rule implementing the NRSRO provisions of the Dodd-Frank Act and proposed a series of new rules and rule amendments to implement the balance of those provisions. In addition, during that time, regulators in other jurisdictions, such as the European Union and Japan, have also instituted new legal and regulatory requirements that apply to NRSROs with operations in those jurisdictions.<sup>22</sup> The NRSROs have been required to implement policies and procedures to keep pace with the changing regulatory landscape. In particular, NRSROs with international operations have been challenged to implement changes that satisfy each jurisdiction's requirements.

3. Each of the three larger NRSROs has made changes to improve its operations since the 2007-08 examinations.

In July 2008, the Commission made public a staff report summarizing issues identified during staff examinations of Fitch, Moody's, and S&P that occurred during 2007-08 (the "2008 Public Report").<sup>23</sup> These examinations focused on the NRSROs' rating of subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") and focused on activities that occurred before each agency became registered as an NRSRO and subject to the NRSRO rules. The 2008 Public Report noted several concerns about the examined NRSROs' operations related to RMBS and CDO ratings, including concerns about the sufficiency of resources devoted to ratings and surveillance, adequacy of disclosures, documentation of the ratings process, and management of conflicts of interest. Each of the three larger NRSROs appears to have devoted notable resources and effort to responding to the concerns and recommendations outlined in the 2008 Public Report.

4. Two of the smaller NRSROs have recently changed ownership.

One of the smaller NRSROs was recently acquired by a much larger company currently involved in credit rating services. It appears that this acquisition may result in the new parent company devoting additional resources to expand the NRSRO's business and market share.

Another of the smaller NRSROs was recently acquired by an outside party that appears to have already devoted significant resources to expanding the NRSRO's business and market share. In

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<sup>22</sup> See Regulation (EC) No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, as amended (2011 O.J. (L145) 54, at 30); Act for Partial Amendment to the Financial Instruments and Exchange Act, enacted on June 17, 2009 and promulgated on June 24, 2009 (Act No. 58 of 2009), amending the Financial Instruments and Exchange Act (Act No. 25 of 1948).

<sup>23</sup> See *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies* (July 2008), available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

this case, the new ownership has committed to addressing Staff examination findings relating to the prior ownership and management team.

## B. Statutory Review Areas

In the following sections, the Staff has organized the summary of its findings in terms of the Section 15E(p)(3)(B) mandated review areas. The Staff notes that some of the findings are applicable to multiple review areas.

### 1. Conducting Business in Accordance with Policies, Procedures, and Methodologies

Section 15E and Commission rules require that NRSROs maintain and enforce various written policies and procedures, including policies and procedures relating to preventing the misuse of material, nonpublic information, managing conflicts of interest, and dealing with complaints. In particular, Rule 17g-2(a)(6) requires NRSROs to make and retain a record documenting the procedures and methodologies used by the NRSRO to determine credit ratings. Those procedures and methodologies must be disclosed in Exhibit 2 to Form NRSRO.

The Staff's review of whether each NRSRO conducted business in accordance with its policies, procedures, and methodologies focused on reviewing the documentation of ratings activity for a selected number of issuers to determine whether the NRSRO had followed its procedures in each case. In addition, the Staff performed testing of whether each NRSRO was following its procedures to protect material nonpublic information. Finally, the Staff's reviews of the remaining seven mandated review areas also involved testing of whether each NRSRO conducted business in accordance with its policies, procedures, and methodologies. The Staff's essential findings in those other areas are discussed in later sections of this Report.

The Staff's essential findings in this area are as follows:

- a) *One of the larger NRSROs reported that it had failed to follow its methodology for rating certain asset-backed securities.*

During the Staff's examinations, one of the larger NRSROs reported that it had erroneously applied its ratings methodology to ratings of certain asset-backed securities and placed a considerable number of these ratings under review.<sup>24</sup> The Staff's initial review of the circumstances surrounding this error raised several concerns. First, the error resulted in the issuance of ratings that were inconsistent with the NRSRO's methodologies. Second, the Staff is concerned about the timeliness with which the error was discovered, disclosed, and remediated. Third, the Staff's inquiry into this issue raised concerns about the sufficiency of resources the NRSRO devoted to the surveillance of asset-backed securities ratings and whether the NRSRO is following its published criteria for placing asset-backed securities ratings under review.

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<sup>24</sup> The NRSRO reported this analysis error as the Staff was conducting its examination. Thus, report of the error occurred outside the Review Period, but application of the erroneous analysis did fall within the Review Period.

Importantly, the Staff is concerned about the extent to which market share and business considerations may have contributed to (1) the rating error and to the delay in discovering, disclosing, and remediating the error; (2) the delay in placing certain asset-backed securities ratings under review; and (3) the resources the NRSRO devotes to surveillance of asset-backed securities ratings.

The Staff recommended that the NRSRO conduct a comprehensive internal review of the circumstances surrounding this error. In addition, the Staff recommended that the NRSRO review the adequacy of the resources the NRSRO devotes to surveillance of its asset-backed securities ratings and whether it follows its disclosed procedures for placing ratings under review. The Staff plans to further review these issues and the NRSRO's responses.

- b) One of the smaller NRSROs appears to have been slow to disclose changes to its rating methodology for certain asset-backed securities and how those changes would apply to its ratings, and slow to apply those changes to outstanding ratings of affected asset-backed securities.*

One of the smaller NRSROs appears to have made changes to its methodology for assigning ratings to certain asset-backed securities, but failed for several months to publicly disclose those changes and how they applied to its ratings. In addition, this NRSRO appears to have delayed applying those changes to potentially affected outstanding ratings, in some cases, for more than a year. The Staff's initial review of the circumstances surrounding this methodology change raised several concerns. First, the delay in publicly disclosing the change appears to have resulted in the issuance of ratings that were inconsistent with the NRSRO's disclosed methodologies. Second, the Staff is concerned that applying the changed methodology to new issue asset-backed securities ratings, without a public disclosure of the change, may have resulted in selective disclosure of the methodology change to those market participants involved in the new issuance of asset-backed securities. Third, the NRSRO appears to have failed to follow its disclosed policies and procedures for surveillance of asset-backed securities ratings. Fourth, the delay in applying the changes to the outstanding ratings may have resulted in a prolonged period where older ratings were determined in a manner inconsistent with more recently issued ratings to which the changed methodology had been applied. Finally, the Staff is concerned about the extent to which the lack of resources devoted to the rating and surveillance process and market share and business considerations may have contributed to the delays in disclosure and application of the methodology change, and the failure to follow the surveillance policies and procedures for asset-backed securities.

The Staff recommended that the NRSRO conduct a comprehensive internal review of the circumstances surrounding implementation of the methodology change. In addition, the Staff recommended that the NRSRO evaluate its internal controls to ensure that methodology changes are promptly disclosed and applied to new and existing ratings in a consistent manner and that it follow its disclosed surveillance policies and procedures. Finally, the Staff recommended that the NRSRO review the adequacy of the resources the NRSRO devotes to applying changes to methodologies to existing asset-backed securities ratings. The Staff plans to further review these issues and the NRSRO's responses.

- c) *Two of the smaller NRSROs had notable instances of apparent failures to follow the policies and procedures for committee review of rating actions.*

Two of the smaller NRSROs appear to have failed to follow their policies and procedures with regard to the frequency with which rating committees reviewed asset-backed securities ratings. In the case of one of these NRSROs, the failure to follow the procedure may have resulted from the policy being unclear.

The Staff recommended that each NRSRO follow its policies and procedures for committee reviews, and, in the case where the policy appeared unclear, that the NRSRO clarify the policy.

- d) *All of the NRSROs failed to follow their ratings procedures in some instances.*

The Staff's ratings file review generally found instances where each of the NRSROs failed to follow all its ratings procedures, in addition to other instances more specifically discussed in this Report. These instances generally involved failing to follow procedures regarding documentation to be maintained with respect to each ratings action. None of these instances appears to have been material. In addition, in some cases, the NRSRO's own internal audit or compliance function identified the problem, and the NRSRO took remedial measures on its own.

The Staff made various recommendations to the NRSROs regarding improvements to following ratings documentation procedures. The recommendations generally involved enhancing internal controls to ensure that ratings procedures are followed, including recommendations for enhanced training regarding new procedures.

## 2. Management of Conflicts of Interest

Section 15E(h)(1) requires NRSROs to have and enforce written policies and procedures to address and manage conflicts of interest. Those policies and procedures must be disclosed in Exhibit 7 to Form NRSRO. Rule 17g-5(b) lists certain conflicts of interest that an NRSRO cannot have unless the conflict is disclosed and the NRSRO has and enforces policies and procedures to address and manage the conflict, and Rule 17g-5(c) lists certain other conflicts of interest that are absolutely prohibited. In Exhibit 6 to Form NRSRO, an NRSRO must disclose material conflicts of interest.

The Staff's essential findings in this area are as follows:

- a) *Two of the smaller NRSROs appeared to have troubling weaknesses with respect to their employee securities ownership policies and procedures. Each of the three larger NRSROs and four of the smaller NRSROs appeared to have some weaknesses with respect to their employee securities ownership policies and procedures.*

The Staff identified what appeared to be troubling weaknesses in two of the smaller NRSROs' securities ownership policies and procedures and implementation of those policies and procedures. In the case of one of these NRSROs, the securities ownership policies appeared poorly documented, and it was difficult to determine whether the NRSRO's employees had complied with the policies. In this case, it appears that employees—one a key employee—violated the policy by failing to adhere to the requirements of the securities trading pre-approval process. It also appears that the same key employee held securities related to a business sector for which he participated in criteria development, in violation of the policy.<sup>25</sup> In another of the smaller NRSROs, the securities ownership policies and procedures also appeared to be poorly documented, and implementation of the policies, including monitoring and enforcement, appeared haphazard and inconsistent. In fact, the Staff identified one instance where a key analyst of this NRSRO may have directly owned a security of a company that was subject to a rating action in which the analyst participated.<sup>26</sup>

In the case of these two NRSROs, the Staff made recommendations that each enhance its securities ownership policies and procedures, including enhancements to documentation and enforcement.

The Staff also identified what appeared to be some weaknesses in each of the three larger NRSROs' and four of the smaller NRSROs' employee securities ownership policies and procedures. These weaknesses generally involved some instances where the policies may have been unclear or not as comprehensive as may be prudent. In addition, the Staff identified apparent weaknesses in the implementation of these policies, such as apparent inconsistent application of the policies or slow administration of the ownership and trading review process. The Staff made recommendations to each NRSRO regarding strengthening its employee securities ownership policies and procedures, including implementation and enforcement of those policies.

The Staff considers employee securities ownership policies and procedures to be an important control in the management of conflicts of interest, and plans to continue focusing on this area in future reviews.<sup>27</sup>

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<sup>25</sup> The key employee who appears to have violated the policies in this case is no longer with that NRSRO.

<sup>26</sup> Rule 17g-5(c)(2) prohibits an NRSRO from issuing a credit rating where an analyst participating in the rating has a direct ownership interest in the company that is the subject of the rating.

<sup>27</sup> The Staff believes that the employee securities ownership policies and procedures also play a critical role in preventing the misuse of material non-public information. *See* Rule 17g-4 (requiring NRSROs to implement policies and procedures reasonably designed to prevent the misuse of material nonpublic information).

- b) *Two of the larger NRSROs did not have specific policies and procedures for managing the potential conflict of rating issuers that may be significant shareholders of the NRSRO.*

Two of the larger NRSROs issue ratings for companies that may be significant shareholders of the NRSRO or the NRSRO's parent company. The Staff believes that, in cases where the issuer's ownership in the NRSRO is material, this could present a conflict of interest. The Staff recommended that these two NRSROs establish specific policies and procedures to disclose and manage potential conflicts of interest arising from rating an issuer that is a material shareholder.

- c) *The three smaller NRSROs that relied primarily on the subscriber-pay business model appeared to have some weaknesses with respect to their policies and procedures to manage the potential conflict of interest associated with being paid by subscribers for ratings.*

As mentioned above, three of the smaller NRSROs historically have relied on the subscriber-pay business model. The Staff believes that this business model presents certain conflicts of interest inherent in the fact that subscribers, on whom the NRSRO relies, have an interest in ratings actions and could exert pressure on the NRSRO for certain outcomes.<sup>28</sup> As such, an NRSRO operating under this business model should have policies and procedures to manage this potential conflict. The Staff found, however, that the three historically subscriber-based NRSROs appeared to have some weaknesses in their written policies and procedures in this regard. The Staff recommended that these NRSROs enhance their written policies and procedures to manage the conflicts associated with the subscriber-pay business model.

- d) *Two of the smaller NRSROs appeared to have weak policies and procedures to disclose and manage conflicts of interest associated with certain ancillary businesses.*

NRSROs must disclose the conflicts of interest arising from providing ancillary services on Exhibit 6 of Form NRSRO.<sup>29</sup> Like other conflicts, NRSROs must maintain and enforce written policies and procedures to manage any such conflicts. Ancillary services consist of any services that an NRSRO may provide which are not core credit rating services.

One smaller NRSRO failed to disclose and implement policies and procedures to manage conflicts of interest associated with an ancillary service. Another of the smaller NRSROs appeared to have weak policies and procedures to manage conflicts of interest associated with an ancillary service. The Staff recommended that each NRSRO fully disclose and implement policies and procedures to manage the conflicts associated with these ancillary services.

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<sup>28</sup> Rule 17g-5(b)(4) and (5) specifically identify conflicts associated with the subscriber-pay model that an NRSRO must disclose and must have and enforce written policies and procedures to manage.

<sup>29</sup> See Rule 17g-5(a)(1); see also Rule 17g-5(b)(3).



- e) *One of the smaller NRSROs appeared to have weak barriers between its rating analysts and employees of an ancillary service that poses a potential conflict of interest.*

At one of the smaller NRSROs, rating analysts shared office space with employees of an ancillary business unit that provides investment advice. The Staff considers the potential conflicts between the interests of investment advice clients and ratings analytics to be significant. In addition, the potential for the inappropriate dissemination of material nonpublic information among the analysts and investment advice employees is significantly increased where they share office space. The Staff recommended that the NRSRO implement stronger barriers between these lines of business, including physical separation of the employees.

- f) *The Staff identified other areas where the NRSROs' conflicts of interest policies and procedures could be strengthened.*

In addition to the issues otherwise specifically discussed in this Report, the Staff generally noted some other areas where each of the NRSROs could strengthen its conflicts of interest policies and procedures. The Staff made various recommendations to the NRSROs regarding improvements.

### 3. Implementation of Ethics Policies

Each NRSRO has implemented written ethics policies and procedures, and the Staff reviewed those procedures and their implementation as part of these examinations. Much of the content of these policies and procedures addresses topics that are the subject of other Section 15E examination areas. As such, to the extent that the Staff made notable findings with respect to the NRSROs' ethics policies, those findings are addressed in other sections of this Report.

### 4. Internal Supervisory Controls

Section 15E(c)(3) requires that each NRSRO establish an effective internal control structure governing the policies, procedures, and methodologies for determining credit ratings. The Staff reviewed each NRSRO's internal control structure related to determining credit ratings and the NRSRO's overall compliance control structure. The Staff also performed testing of selected procedures.

The Staff's essential findings in this area are as follows:

- a) *Three of the smaller NRSROs appeared to have weak internal supervisory controls.*

Three of the smaller NRSROs appeared to have weak internal supervisory controls. The weaknesses identified at one of these NRSROs included the lack of any internal audit function

and limited compliance personnel relative to the NRSRO's size and recent growth. The weaknesses identified at the second of these NRSROs included weak documentation of policies and procedures, including weak documentation of ratings methodologies and processes, and lack of an internal audit function. The weaknesses identified at the third of these NRSROs included weak documentation of the ratings process, weak internal controls over the ratings process, and lack of an internal audit function.

The Staff made recommendations to these NRSROs regarding enhancements to their internal supervisory control structures.

- b) One of the other smaller NRSROs appeared to have a particularly weak internal supervisory control structure.*

One of the other smaller NRSROs appeared to have a particularly weak internal supervisory control structure. The Staff found significant weaknesses in the NRSRO's internal policies and procedures, including weak and sometimes non-existent documentation of some ratings methodologies and processes, very weak oversight by the designated compliance officer, and a very weak internal control structure. The bulk of the ratings at this NRSRO appear to be assigned by a single person with no effective committee structure or other control structures.

The Staff made several recommendations to this NRSRO regarding enhancements to its internal supervisory controls.

- c) The Staff identified apparent weaknesses in the procedures for publishing pending rating actions at one of the larger NRSROs and three of the smaller NRSROs.*

Rule 17g-4(a)(3) requires an NRSRO to establish and enforce policies and procedures reasonably designed to prevent its pending credit rating actions from being selectively disclosed before being made public. At one of the larger NRSROs, the procedures for disseminating a pending rating action appeared to allow for limited dissemination of a pending rating action in some instances prior to public dissemination. At three of the smaller NRSROs, the Staff identified instances where there appeared to be an unnecessary delay between assignment of a credit rating and publication of the rating action. The Staff is concerned that the apparently unnecessary delay in release and publication of some credit rating actions increases the possibility that pending credit rating actions will be inappropriately disseminated. The Staff recommended that each of these NRSROs consider enhancing its policies and procedures for dissemination of pending credit rating actions.

- d) The Staff identified other areas where the NRSROs' internal supervisory controls could be strengthened.*

In addition to the issues otherwise specifically discussed in this Report, the Staff generally noted some other areas where each of the NRSROs could strengthen its internal supervisory controls. The Staff made recommendations to the NRSROs regarding improvements.

## 5. Governance

Section 15E(t), added by the Dodd-Frank Act, requires that NRSROs have a board of directors and mandates the structure and responsibilities of the board.

The Staff reviewed whether each NRSRO has taken steps to meet the requirements under this new provision. However, the testing of whether the NRSROs have effectively implemented new governing provisions was limited because this provision is new and implementation generally fell outside of the Review Period.

The Staff found that each of the NRSROs has made efforts to comply with the new governance provisions.<sup>30</sup> The Staff noted some instances where the governance structures may not comply with all of the requirements of Section 15E(t) or where implementation appears to be weak. The Staff made recommendations to the NRSROs regarding these concerns. The Staff should be able more comprehensively to test implementation of the new governance provisions in future Section 15E examinations.

## 6. Designated Compliance Officer Activities

Section 15E(j)(1) requires each NRSRO to designate a compliance officer (“DCO”) responsible for administering the policies and procedures established to prevent the misuse of material non-public information and manage conflicts of interest and ensuring compliance with the securities laws. In addition, the DCO is prohibited from engaging in certain activities (Section 15E(j)(2)), is responsible for establishing procedures for the receipt, retention, and treatment of complaints (Section 15E(j)(3)), must be compensated in a manner not linked to financial performance of the NRSRO and that ensures independence (Section 15E(j)(4)), and must submit an annual report to the NRSRO on the compliance of the NRSRO with the securities laws and the NRSRO’s policies and procedures (Section 15E(j)(5)(A)). The NRSRO must file this report with the Commission (Section 15E(j)(5)(B)).

The Staff considers the DCO role to be a critical element helping to ensure an NRSRO’s compliance with securities laws. The Staff expects the DCO at each NRSRO to have sufficient resources, institutional support, and independence to effectively carry out the DCO’s statutory obligations.

The Staff reviewed the role and activities of each NRSRO’s DCO. This review included interviews with each DCO.

The Staff’s essential findings in this area are as follows:

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<sup>30</sup> Three of the smaller NRSROs have requested that the Commission grant them exemptive relief from some of the provisions of Section 15E(t).

- a) *At one of the larger NRSROs, the stability and clarity of the DCO's role can be improved.*

At one larger NRSRO, there have been significant changes in the compliance function, including changes in structure and leadership roles since 2008. During that time, four different people have served as the DCO, and the current DCO is serving on an interim basis.<sup>31</sup> The Staff is concerned that the changes, which continue to the present, have created an environment in which a clearly defined set of roles and responsibilities for the DCO has not yet been fully established.

In addition, the Staff is concerned that this NRSRO's DCO function may not have a prominent enough role within the NRSRO's compliance program to effectively accomplish the statutory mandate. The Staff found some indication that this NRSRO's prior DCOs historically may not have had full access to senior management or full involvement in all compliance functions. In addition, the Staff found some indication that tension between the prior DCOs and other business lines of the NRSRO may have hindered an effective working relationship.

The Staff has expressed concerns that this developing structure of the compliance function at this NRSRO may compromise the DCO's role in the compliance function. The Staff has recommended that this NRSRO make establishing stability in the DCO role a key priority and ensure that the structure of the compliance function will enable the DCO to effectively and independently carry out the DCO's statutory duties.

- b) *At four of the smaller NRSROs, the DCO and compliance function may not have sufficient resources and support to effectively ensure compliance with the securities laws.*

At four of the smaller NRSROs, the Staff identified concerns about the sufficiency of resources devoted to the DCO and compliance functions. These concerns included concerns about the DCO's time being spread across multiple functions, the DCO having limited staff to support carrying out compliance duties, or the DCO potentially not having a prominent enough role within the NRSRO's compliance program to effectively accomplish the DCO's statutory duties. The Staff made recommendations regarding strengthening the role of and resources available to both the DCO individually and the compliance function as a whole.

- c) *At one of the smaller NRSROs, the DCO does not appear able to effectively carry out the necessary DCO duties.*

At one of the smaller NRSROs, the Staff is concerned that the DCO is unable to carry out the DCO duties. The DCO at this NRSRO has very little relevant experience or training to fill the role and demonstrates very little knowledge or understanding of the credit rating business, processes, or applicable laws or rules. The Staff identified several troubling compliance deficiencies and weaknesses at this NRSRO, and many of these concerns appear related to the

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<sup>31</sup> This NRSRO represented that it recently identified a new DCO to serve on a permanent basis, and that the new DCO will assume the role shortly.

lack of an effective DCO. The Staff recommended that this NRSRO evaluate the experience, knowledge, and skills necessary for its DCO to effectively carry out the DCO duties.

*d) The Staff identified some other concerns about the remaining two smaller NRSRO's DCO activities.*

In addition to the issues otherwise specifically discussed in this Report, the Staff generally noted some other concerns about the remaining two smaller NRSRO's DCO activities. The Staff made recommendations to these NRSROs regarding improvements.

## 7. Complaints

Section 15E(j)(3), added by the Dodd-Frank Act, states that an NRSRO's DCO must establish procedures for the receipt, retention, and treatment of (i) complaints regarding credit ratings, models, methodologies, and compliance with the securities laws and the NRSRO's policies and procedures; and (ii) confidential, anonymous complaints by employees or users of credit ratings. Rule 17g-2(b)(8) requires an NRSRO to retain any written complaints received from persons not associated with the NRSRO about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating. The Staff reviewed each NRSRO's policies and procedures for complaints and performed some testing of those procedures. However, the testing was limited because the statutory requirement for complaints is relatively new and implementation of the policies generally fell outside of the Review Period.

The Staff found that all of the NRSROs have established written policies and procedures to address this new requirement. The Staff noted some cases where an NRSRO could provide greater clarity in its written procedures, particularly as regards what constitutes a complaint. The Staff also noted some instances where the written policies and procedures may not cover all of the requirements outlined in the statute. The Staff made recommendations to the NRSROs regarding the identified weaknesses. The Staff should be able to conduct a more comprehensive review and testing of the complaints procedures in next year's Section 15E examinations.

## 8. Post-Employment Policies

Section 15E(h)(4)(A)(i), added by the Dodd-Frank Act, requires an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed to ensure that the firm will review a former employee's involvement in the determination of credit ratings for a person or an issuer, underwriter, or sponsor of a security or money market instrument if the former employee is now employed by such person or entity. The Staff reviewed each NRSRO's "look-back" policies and procedures and performed some testing of those procedures. However, the testing was limited because the statutory requirement for look-backs is relatively new and implementation of the policies generally fell outside of the Review Period.

The Staff found that all of the NRSROs have established written policies and procedures to address this new look-back requirement. The Staff noted some weaknesses in some of the NRSROs' plans and ability to implement the new policies. The Staff also noted some instances where the written policies and procedures may not cover all of the requirements outlined in the

statute or could otherwise be strengthened. The Staff made recommendations to the NRSROs regarding the identified weaknesses. The Staff should be able to conduct a more comprehensive review and testing of the look-back procedures in next year's Section 15E examinations.

### C. Other Findings and Observations

The Staff had findings and observations other than those falling under the statutory review areas. The Staff's essential findings in those other areas are as follows:

1. The public disclosures made by one of the smaller NRSROs appear to be incomplete and misleading in many respects.

Each NRSRO must make various public disclosures about its operations on Form NRSRO. An NRSRO must publicly disclose in Exhibit 2 to Form NRSRO a general description of its credit rating procedures and methodologies. This description must be "sufficiently detailed to provide users of credit ratings with an understanding of the processes employed by the NRSRO in determining credit ratings" and specific areas must be addressed. The instructions for Exhibit 2 to Form NRSRO also require the NRSRO to provide a description of "the structure and voting process of committees that review or approve credit ratings."<sup>32</sup> Exhibit 8 to Form NRSRO requires an NRSRO to provide certain information concerning the NRSRO's credit analysts, including the total number of credit analysts and credit analyst supervisors.

The disclosures of one of the smaller NRSROs on its Form NRSRO appear to be incomplete and misleading in many respects. This NRSRO has failed to disclose certain rating methodologies, and its disclosures of other rating methodologies appear weak. In addition, this NRSRO's public descriptions of its committee process appear misleading. Finally, this NRSRO's disclosures about the number of analysts working on credit ratings appear misleading. The Staff made recommendations to this NRSRO to reevaluate and improve its disclosures.

2. One of the smaller NRSROs may not characterize certain designations it assigns to securities as credit ratings.

One of the smaller NRSROs may not characterize certain designations it assigns to securities as credit ratings. The characterization of these designations has important implications; for example, if the designations are credit ratings, they are subject to the NRSRO's policies and procedures for assigning credit ratings, including the committee process and documentation, and to public disclosure as rating actions. The Staff recommended that the NRSRO conduct a comprehensive review of these designations to determine whether they should be considered credit ratings.

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<sup>32</sup> Form NRSRO Instructions, Exhibit 2.

3. The public disclosures of each of the seven smaller NRSROs could be improved.

As mentioned, NRSROs make official public disclosures on Form NRSRO, but also make public statements and representations in a number of different ways, including via websites and press releases. The Staff believes all NRSRO public statements and representations should be accurate, complete, clear, and timely. In addition to disclosure issues otherwise specifically discussed in this Report, the Staff identified areas in which the seven smaller NRSROs could improve their public statements. These areas generally included Form NRSRO disclosures, such as internal procedures and accurate reporting of the number of ratings, additional information and analysis posted on websites, differentiation between NRSRO ratings and ratings of non-NRSRO registered affiliates, and clarifying whether translated documents were full translations of documents originally written in another language. The Staff made several recommendations for improvements.

#### **IV. CONCLUSION**

The Staff conducted the first of its annual Section 15E examinations of each of the ten credit rating agencies registered with the Commission as NRSROs. The Staff had many findings and observations and made corresponding recommendations to each NRSRO for improvements.