

MEMO# 25534

October 5, 2011

SEC Staff Issues First Required Annual Report on NRSRO Examinations

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TO: FIXED-INCOME ADVISORY COMMITTEE No. 71-11
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 49-11
SEC RULES MEMBERS No. 116-11 RE: SEC STAFF ISSUES FIRST REQUIRED ANNUAL REPORT ON NRSRO EXAMINATIONS

The staff of the Securities and Exchange Commission (SEC) recently published a summary report of its examinations of the ten Nationally Recognized Statistical Rating Organizations (NRSROs) registered with the SEC. [\[1\]](#) The Report indicates that the staff identified concerns at each of the NRSROs. It notes that the staff made recommendations to the NRSROs to address those concerns, and that in some cases the NRSROs have already taken steps to do so. The Report is summarized below.

As background, the Report describes the statutory framework and rules governing NRSROs, including various enhancements made by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Among other things, new provisions added to Section 15E of the Securities Exchange Act of 1934 require the SEC to examine each NRSRO at least annually and specify certain items the SEC must review in such examinations. [\[2\]](#) In addition, the SEC must make available to the public an annual report summarizing: (i) the “essential findings” of the NRSRO examinations; (ii) any “material regulatory deficiencies” identified in those findings; and (iii) whether the NRSROs have appropriately addressed the recommendations of the SEC contained in previous annual reports. The background section of the Report also identifies and provides basic information about the ten NRSROs the staff examined. [\[3\]](#)

The Report summarizes the “essential findings” [\[4\]](#) of the staff’s examinations, which generally focused on NRSRO activities for the period covering December 1, 2009 through August 1, 2010. This section of the Report begins with the following general observations:

1. The NRSROs appear to be trending even more toward the issuer-pay business model (in which the NRSRO receives compensation from obligors for rating the obligor or securities issued by the obligor).
2. The NRSROs have been subject to substantial, relatively new legal and regulatory requirements.

3. Each of the three larger NRSROs has made changes to improve its operations since the 2007-08 examinations.
4. Two of the smaller NRSROs have recently changed ownership.

The Report then discusses the staff's specific findings, organized in terms of the review areas mandated by statute. [\[5\]](#) The staff's findings are listed below. [\[6\]](#)

Conducting Business in Accordance with Policies, Procedures, and Methodologies

- One of the larger NRSROs reported that it had failed to follow its methodology for rating certain asset-backed securities.
- 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.
- Two of the smaller NRSROs had notable instances of apparent failures to follow the policies and procedures for committee review of rating actions.
- All of the NRSROs failed to follow their ratings procedures in some instances.

Management of Conflicts of Interest

- 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 in this regard.
- Two of the larger NRSROs did not have specific policies and procedures for managing the potential conflict of interest associated with rating issuers that may be significant shareholders of the NRSRO.
- 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.
- Two of the smaller NRSROs appeared to have weak policies and procedures to disclose and manage conflicts of interest associated with certain ancillary businesses.
- 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.
- The staff identified other areas where the NRSROs' conflicts of interest policies and procedures could be strengthened.

Internal Supervisory Controls

- Three of the smaller NRSROs appeared to have weak internal supervisory controls.
- One of the other smaller NRSROs appeared to have a particularly weak internal supervisory control structure.
- 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.
- The staff identified other areas whether the NRSROs' internal supervisory controls could be strengthened.

Designated Compliance Officer (DCO) Activities

- At one of the larger NRSROs, the stability and clarity of the DCO's role can be improved.
- 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 one of the smaller NRSROs, the DCO does not appear able to effectively carry out the necessary DCO duties.
- The staff identified some other concerns about the remaining two smaller NRSROs' DCO activities.

Findings and Observations Outside of Statutory Review Areas

- The public disclosures made by one of the smaller NRSROs appear to be incomplete and misleading in many respects.
- One of the smaller NRSROs may not characterize certain designations it assigns to securities as credit ratings.

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The Report states that 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.

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endnotes

[1] 2011 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization (September 2011) ("Report"), available at http://www.sec.gov/news/studies/2011/2011_nrsro_section15e_examinations_summary_report.pdf.

[2] The required items are: (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.

[3] For purposes of the Report, the staff divided the ten NRSROs into two groups: the three "larger" NRSROs—Fitch, Inc. Moody's Investors Service, Inc., and Standard & Poor's Ratings Services—and the seven "smaller" NRSROs—A.M. Best Company, Inc., DBRS, Inc., Egan-Jones Rating Company, Japan Credit Rating Agency, Ltd., Kroll Bond Rating Agency, Morningstar Credit Ratings, LLC, and Rating and Investment Information, Inc. In discussing the staff's examination findings, the Report does not identify individual firms by name.

[4] The Report states that for purposes of the Report, "'essential findings' includes the

Staff’s notable observations and concerns” and that these 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.” Report at 9. The Report further indicates that as of the date of the Report, “the Commission has not determined that any finding discussed in [the] Report constitutes a ‘material regulatory deficiency,’ but may do so in the future.” If so, the staff will include the NRSRO’s response in a future summary report. Id.

[5] See supra note 2.

[6] The Report notes that some of the findings are applicable to multiple review areas. Thus, for example, the Report does not include a separate section on ethics policies because to the extent the staff made notable findings with respect to NRSROs’ ethics policies, those findings were addressed in other sections. In addition, the Report explains that testing was limited in some areas where the requirements are relatively new and compliance generally fell outside of the review period. These included governance, complaints, and post-employment policies.