

**MEMO# 33126**

February 23, 2021

# **SEC Files a Civil Action Against Morningstar Credit Ratings LLC for Violations of the Federal Securities Laws**

[33126]

February 23, 2021 TO: ICI Members  
Chief Compliance Officer Committee  
Chief Risk Officer Committee  
Operations Committee

SEC Rules Committee SUBJECTS: Litigation & Enforcement RE: SEC Files a Civil Action Against Morningstar Credit Ratings LLC for Violations of the Federal Securities Laws

Last week, the US Securities and Exchange Commission (SEC) filed a complaint to initiate a civil suit against Morningstar Credit Ratings, LLC.[\[1\]](#) The Complaint alleges various violations of the Securities Exchange Act of 1934 (the “Exchange Act”) based on conduct described below. It demands a jury trial and seeks sanctions including a permanent injunction, disgorgement of all ill-gotten gains, and civil money penalties.

## **Summary of the Complaint’s Allegations**

The Complaint begins by noting the important role credit rating agencies play in maintaining market integrity. It notes that, when rating agencies depart from “a disciplined and transparent approach to determining credit ratings, the effects for the markets can be harmful.” With respect to Morningstar, while Morningstar publicly disclosed the rating process and methodology it uses to rate commercial mortgage-backed securities (CMBS), the firm failed to disclose that its analysts could materially depart from this methodology and make “loan specific” adjustments when rating securities. As described in detail in the Complaint, Morningstar’s adjustments resulted in publishing inaccurate ratings.

According to the Complaint, from at least 2015-2016, Morningstar rated approximately \$30 billion in CMBS from 30 transactions. Its underwriting process involved determining key cash flow and valuation amounts for the commercial properties and associated loans backing each CMBS transaction. Morningstar failed, however, to disclose that, as part of its underwriting process, its analysts were permitted to adjust the stresses used to rate the securities on a “loan specific” basis. These adjustments could materially alter a securities rating. The Complaint notes that, while the adjustments were used to both increase and decrease property cash flow and valuation stresses, “the adjustments were overwhelmingly used to ease those stresses, which lowered expected losses for many classes of CMBS

certificates that Morningstar rated.” Using the undisclosed adjustments enabled Morningstar to lower the credit enhancements for many of the classes of securities Morningstar rated, which, in turn, enabled Morningstar to assign higher credit ratings to those classes to the benefit of those issuers that hired and paid Morningstar.

The Complaint explains that Morningstar used these undisclosed stress adjustments in all 30 CMBS transactions that it rated during the relevant period. They resulted in Morningstar assigning

. . . one or more higher ratings in at least one class of certificates in the vast majority of these transactions. Morningstar also used the stress adjustments in many of the transactions to rate millions of dollars of CMBS as investment-grade securities when Morningstar would have rated those securities as below-investment grade had Morningstar rated the CMBS in accordance with its disclosed methodology.

In addition to its failure to accurately disclose its rating methodology, according to the Complaint, in rating these securities, Morningstar failed to establish and enforce an effective internal control structure that governed its rating adjustments. In particular, Morningstar’s internal control structure relating to the determination of CMBS ratings omitted elements designed to assess whether its analysts appropriately adjusted loan stresses. The lack of these effective controls enabled analysts to make loan adjustments not permitted by or disclosed in Morningstar’s rating methodology. Moreover, the Complaint notes that Morningstar sometimes used these stress adjustments on a portfolio-wide basis, “meaning that Morningstar used the same stress adjustment at particular ratings categories for each of the 100 or so loans in a CMBS transaction portfolio.”

In sum, Morningstar’s stress adjustments “resulted in materially higher Morningstar ratings for hundreds of millions of dollars’ worth of CMBS certificates. In the aggregate, an analysis of the models shows that the adjustments resulted in higher Morningstar ratings for at least 100 CMBS classes.”[\[2\]](#) The Complaint notes that Morningstar “seldom” made stress adjustments that resulted in lowering ratings. As a result, the adjustments it made benefitted the issuers that paid Morningstar for the ratings because it enabled these issuers to pay investors less interest than they otherwise would have paid without the adjustments.

## **The Alleged Violations of the Exchange Act**

According to the Complaint, the above described conduct violated the following provisions of the Exchange Act:

- Section 15E(b)(2)(A) and Rule 17g-1(f) of the Exchange Act by Morningstar failing to (1) describe the methodologies that it used to determine certain credit ratings and (2) file annual certifications that included required information;
- Rule 17g-7(a)(1)(ii)(B) of the Exchange Act by Morningstar failing to disclose, as required by law, the version of the methodologies it used to determine its credit ratings; and
- Section 15E(c)(3)(A) of the Exchange Act by Morningstar failing to establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to its methodologies for determining specified CMBS credit ratings.

Tamara K. Salmon  
Associate General Counsel

**endnotes**

[1] See *US Securities and Exchange Commission v. Morningstar Credit Ratings, LLC* (SDNY 21-CV-1359)(February 16, 2021)(the “Complaint”), which is available at: <https://www.sec.gov/litigation/complaints/2021/comp-pr2021-29.pdf>. The SEC’s press release announcing this suit is available at: <https://www.sec.gov/news/press-release/2021-29>.

[2] Paragraphs 50 and 51 of the Complaint provide examples of the CMBS receiving higher ratings as a result of these undisclosed adjustments. For example, Morningstar rated securities as AAA, AA-, A-, and BBB- that, respectively, should have been rated AA+, A-, BBB, and CCC-.

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