

**UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION**

SECURITIES EXCHANGE ACT OF 1934
Release No. 88880 / May 15, 2020

ADMINISTRATIVE PROCEEDING
File No. 3-19802

In the Matter of

**MORNINGSTAR CREDIT RATINGS,
LLC**

Respondent.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS
PURSUANT TO SECTIONS 15E(d) AND 21C
OF THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15E(d) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against Morningstar Credit Ratings, LLC (“MCR” or “Respondent”).

II.

In anticipation of the institution of these proceedings, MCR has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, MCR consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15E(d) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and MCR's Offer, the Commission finds¹ that:

Summary

1. MCR violated Exchange Act Rule 17g-5(c)(8)(i), a conflict of interest rule, by issuing or maintaining credit ratings where MCR employees who participated in determining or monitoring the credit ratings also participated in the sales or marketing of a product or service of MCR.

2. Despite the effective date of Rule 17g-5(c)(8)(i) on June 15, 2015, asset-backed securities ("ABS") analysts at MCR, often encouraged and directed by MCR's then-director of business development for ABS, identified and contacted prospective clients to arrange marketing calls and marketing meetings, offered to provide indicative ratings to potential clients, and had follow-up communications and interactions with prospective clients, all for the purpose of persuading potential clients to hire MCR to rate ABS. For example, an ABS analyst at MCR wrote a commentary specifically aimed at a particular issuer and sent it to the issuer with the purpose of persuading the issuer to become a client of MCR. In certain instances, ABS analysts at MCR made multiple solicitations to prospective clients over the course of months. These activities were undertaken with the knowledge of other senior MCR managers.

3. MCR also failed to establish, maintain, and enforce written policies and procedures reasonably designed to ensure compliance with Rule 17g-5(c)(8)(i) and therefore violated Section 15E(h)(1) of the Exchange Act.

Respondent

4. MCR, formerly known as Realpoint LLC, is headquartered in New York, NY and registered as a Nationally Recognized Statistical Rating Organization ("NRSRO") in 2008. MCR is a wholly owned subsidiary of Morningstar, Inc., a publicly-traded company with common stock listed on the Nasdaq Stock Market.

Background

A. Prohibition of Analysts Engaging in Sales and Marketing Under Rule 17g-5(c)(8)(i)

5. In the wake of the financial crisis, Congress mandated that the Commission prescribe rules to improve the regulation of NRSROs. In enacting the Dodd-Frank Act, Congress

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

specifically found that, “[i]n certain activities, particularly in advising arrangers of structured financial products on potential ratings of such products, credit rating agencies face conflicts of interest that need to be carefully monitored. . . .” Dodd-Frank, § 931. One such conflict is the “issuer pays” model, whereby issuers or underwriters pay NRSROs to determine the credit ratings with respect to the securities they issue or underwrite. To mitigate the risk of undue influence arising from that conflict, Congress directed the Commission to issue rules to prevent the sales and marketing considerations of an NRSRO from influencing the production of ratings by the NRSRO. Exchange Act Section 15E(h)(3).

6. As directed by Congress, the Commission issued Rule 17g-5(c)(8)(i), which is intended to insulate rating analysts from business pressures by separating rating agencies’ business-getting function from their analytical (that is, rating-determining) function. In relevant part, that rule prohibits any rating agency from “issu[ing] or maintain[ing] a credit rating where a person within the [NRSRO] who participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative and quantitative models, also . . . [p]articipates in sales or marketing of a product or service of the [NRSRO] or a product or service of an affiliate of the [NRSRO]” 17 C.F.R. § 240.17g-5(c)(8)(i).

7. In the adopting release for Rule 17g-5(c)(8), the Commission emphasized that:

In practice, the Commission believes the amendment will require an NRSRO to prohibit personnel that have any role in the determination of credit ratings or the development or modification of rating procedures or methodologies from having any role in sales and marketing activities. It also will require an NRSRO to prohibit personnel that have any role in sales and marketing activities from having any role in the determination of credit ratings or the development or modification of rating procedures or methodologies. Consequently, these functions will need to be separate.

Nationally Recognized Statistical Rating Organizations, Final Rule, 79 Fed. Reg. 55,078, 55,108 (Sept. 15, 2014).

8. In adopting the rule, the Commission noted that it sets forth “an absolute prohibition,” and explained that:

This absolute prohibition should result in internal policies, procedures, and organizational solutions that isolate the analytical function from sales and marketing considerations within the NRSRO. To the extent that the absolute prohibition prevents credit analysts that participate in the determination of credit ratings from being influenced by sales and marketing considerations, this should curb potential conflicts of interest related to “rating catering” practices

that have been suggested by anecdotal evidence and academic literature. Isolating the production of credit ratings and the development of procedures and methodologies for determining credit ratings from sales and marketing considerations should promote the integrity and quality of credit ratings to the benefit of their users.

79 Fed. Reg. at 55,091-92.

B. MCR’s Failure to Sufficiently Separate the Business Development and Rating Analytics Functions in its ABS Rating Business

9. In 2010, MCR began efforts to expand its footprint in the credit rating business. MCR focused on growing its rating business in credit sectors that were not already dominated by large, well-established rating agencies. Beginning in 2015, one of the sectors that MCR focused on was esoteric ABS, such as bonds with cash flow from aircraft leases and whole businesses serving as the securitized collateral.

10. MCR’s ABS analysts were responsible for creating analytical methodologies, using them to rate particular deals, generating research and commentary regarding topics such as the creditworthiness of particular asset classes and the effects of certain market events, and presenting or speaking to market participants about MCR’s credit analysis and views on the market.

11. MCR’s ABS business development director was responsible for identifying, contacting, and maintaining relationships with potential clients (including issuers and bankers who arrange deals), persuading potential clients to hire MCR to rate deals, and persuading investors to accept deals rated by MCR.

12. MCR’s written policies and procedures failed sufficiently to address and manage the conflict of interest relating to sales and marketing prohibited by Rule 17g-5(c)(8)(i). Specifically, MCR’s Analytical Firewall Policy and Code of Conduct only prohibited analysts from discussing fees for ratings services or negotiating engagement terms. Those policies did not prohibit analysts from engaging in other sales and marketing activity.

13. The deficient policies contributed to MCR’s failure sufficiently to keep the analytical rating function and the sales and marketing function separate. One example of this failure occurred in July 2015. MCR’s ABS business development director was pursuing Company 1 as a potential ratings client and he wanted to attend an event held at Company 1’s office so that he could continue the pursuit. The ABS business development director was unable to attend the event due to a scheduling conflict. Accordingly, the ABS business development director requested Analyst A to attend in his place, which Analyst A did. After the event, the ABS business development director emailed Analyst A: “Sorry to bother you on a weekend. . . . Did you make it

over to the [Company 1] event? Was it good? Anything coming out of it for us?” Analyst A replied that he enjoyed the event and that he met the CEO of Company 1. That Monday, Analyst A followed up with an email pitch to the CEO of Company 1: “As discussed, we would love to meet you and the team to show you how we are different. We have recently rated an unsecured consumer loan backed transaction, and have a strategic focus on emerging and esoteric assets. . . . Please let us know who on your team can help us set up a brief introductory meeting.” Analyst A copied the ABS business development director on his email. The ABS business development director later used that email as a prompt to further pursue Company 1 as a prospective client. According to the ABS business development director, Analyst A’s communications with Company 1 were efforts at marketing MCR’s ABS ratings services.

C. MCR Issued and Maintained Ratings in Contravention of Rule 17g-5(c)(8)(i)

14. In an effort to grow MCR’s ABS rating business, MCR’s ABS business development director instructed ABS analysts to identify and initiate contacts with potential clients (referred to as “targets”), set up marketing calls and marketing meetings with them, and offer them indications. MCR’s ABS business development director also instructed ABS analysts to (i) solicit potential clients at industry conferences, (ii) repeatedly follow up with those potential clients, and (iii) encourage potential clients to attend marketing meetings with MCR. Analysts understood that the goal of their contacts was to persuade potential clients to hire MCR to rate ABS. These activities were undertaken with the knowledge of senior MCR managers.

15. Analysts solicited business from potential clients whom they knew, as well as potential clients whom they did not know but whom they identified through their own initiative, or who were identified to them by MCR’s ABS business development director.

16. For example, an MCR ABS analyst (“Analyst B”) undertook extensive efforts to recruit Company 2, an issuer in the ABS marketplace, as an MCR client. In mid-June 2015, with the intention of making Company 2 an MCR client, Analyst B contacted one of his contacts there, Company 2’s head of capital markets. Analyst B secured an introductory call between representatives of Company 2 and MCR to “discuss any possibilities of potentially working together in the future.” During that call, Analyst B stated that MCR was “very interested in putting its experience/knowledge in structured settlement ABS to work,” and he expressed the hope that MCR would be “given the chance to assist [Company 2] in future ratings (whether your upcoming ABS or the anticipated residual securitization that is contemplated).” Two weeks later, Analyst B followed up to inquire whether Company 2 had reviewed marketing materials sent by MCR’s ABS business development director. Analyst B also offered to provide Company 2 with an indicative rating on a security issued by Company 2. After Company 2 failed to respond to this follow-up, Analyst B decided to write and publish a commentary on the credit strength of certain notes in Company 2’s deals, and to follow up with Company 2 again after the publishing the commentary. The commentary mentioned Company 2 by name, was tailored to the securities that Company 2 issues, and said that, based on MCR’s view of such transactions, MCR would assign higher ratings to the notes in Company 2’s deals than other credit rating agencies. Analyst B sent the commentary to Company 2 on the same day that it was published. In the cover email, Analyst B requested

another meeting with representatives of Company 2 at an upcoming industry conference. Analyst B's efforts did not immediately yield fruit, but MCR was eventually hired to rate a Company 2 securitization.

17. During his tenure at MCR, the ABS business development director maintained an Excel spreadsheet called the "contact log," which contained a comprehensive record of MCR's efforts to establish and maintain relationships with potential ABS rating clients and persuade them to hire MCR. The contact log listed a "lead" for each client or potential client. The ABS analysts not only undertook the initial outreach, but in many instances they also engaged in follow-up for weeks or months. ABS analysts were listed, singly or with others, as the "lead" for more than 45 prospective client relationships.

18. The contact log was regularly circulated to the ABS analysts, stored in a shared drive that the ABS analysts could access, and regularly updated based on the ABS analysts' sales and marketing efforts.

19. Senior MCR managers and the ABS analytical staff received regular reports on the status of MCR's client recruitment efforts, including sales and marketing by ABS analysts.

20. In self-evaluations, ABS analysts touted their business development efforts. Analyst B credited himself with introducing multiple potential clients and with "helping" MCR's "outreach" by meeting with potential clients at a conference. Similarly, in a memorandum to management, Analyst A wrote, "I am involved in introducing and building relationships that resulted in referrals and repeat engagements for us."

21. MCR issued and maintained ABS ratings to certain of the entities on the log where an analyst within the NRSRO participated in determining or monitoring the credit rating and participated in the sales or marketing of a product or service of the NRSRO.

22. Since June 15, 2015, when Rule 17g-5(c)(8)(i) became effective, MCR issued and maintained certain ABS ratings in contravention of Rule 17g-5(c)(8)(i).

23. Ratings issued and maintained in contravention of Rule 17g-5(c)(8)(i) have been withdrawn by MCR.

Violations

24. As a result of the conduct described above, MCR willfully violated Rule 17g-5(c)(8)(i) of the Exchange Act, which forbids NRSROs from issuing or maintaining a credit rating where a person within the NRSRO who participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the

credit rating, also participates in sales or marketing of a product or service of the NRSRO or an affiliate of the NRSRO.²

25. MCR also failed to establish, maintain, and enforce written policies and procedures reasonably designed to ensure compliance with Rule 17g-5(c)(8)(i), and therefore violated Section 15E(h)(1) of the Exchange Act.

IV.

Undertakings

MCR has undertaken to do the following:

A. **Training.** Within 180 days of the entry of this Order, MCR will conduct a live training program addressing the Commission's conflict of interest rules, including but not limited to the prohibitions set forth in Rule 17g-5(c)(8). This training program shall educate attendees regarding applicable rules and regulations and relevant policies and procedures. This training shall also explain how employees can raise concerns and the avenues for doing so, including internally and directly with the SEC through the Whistleblower Program. Attendance at this training program will be mandatory for all current MCR personnel who work or worked in the ABS rating group, each of whom shall certify in writing that he or she attended this program. Within 180 days of the entry of this Order, MCR also will create policies or procedures to ensure that this training is provided to all new employees in their first 14 days of employment, and repeated annually for all employees. As part of this policy or procedure, both new employees and recipients of the annual training shall certify in writing that: (a) they attended the training, and (b) within the past year, they have not both (i) participated in determining or monitoring credit ratings, or developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models, and (ii) participated in sales or marketing of a product or service of MCR or an MCR affiliate. MCR or any successor will maintain the training program for not less than two years after entry of this order. MCR will certify, through its duly authorized officer, that it has conducted the above-described training program and has created the above-described policies or procedures.

B. **Review and Correction of Documentation and Internal Controls, Policies, and Procedures.** MCR will integrate its operations with those of DBRS, another NRSRO. Thereafter, MCR's existing credit rating functions will be governed by DBRS's internal controls, policies, and procedures. In the event that such integration has not occurred within 180 days of the entry of this Order, MCR will (i) review its internal controls, policies, and procedures and take the necessary actions to ensure that they accurately reflect the Commission's conflict of interest rules set forth in Rule 17g-5, and (ii) evaluate and strengthen the internal controls intended to isolate analysts from participating in sales or marketing, or from being subjected to influence by sales or marketing considerations.

² "Willfully," for purposes of imposing relief under Section 15E(d)(1) of the Exchange Act "means no more than that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000)(quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965).

C. Certificate of Compliance. A duly authorized officer of MCR shall certify in writing, under penalty of perjury, compliance with each of the above undertakings (the “Certificate of Compliance”). In the event MCR has ceased to exist at the time the certification is due, MCR has provided for certification to be made by a duly authorized officer of DBRS. The certification shall identify each of the above undertakings with which MCR believes it has complied and shall provide written evidence of compliance in the form of a narrative which is supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and MCR agrees to provide, and pursuant to the integration of its operations with DBRS, has arranged that DBRS if necessary shall provide, such evidence. The certification and supporting material shall be submitted to Celia Moore, Assistant Regional Director, U.S. Securities and Exchange Commission, Boston Regional Office, 33 Arch St., 24th Fl., Boston, MA 02110. This certification shall be submitted no later than 45 days following the time periods set out in Paragraphs A and B above. Respondent agrees that if the Division of Enforcement believes that Respondent has not satisfied these undertakings, it may petition the Commission to reopen the matter to determine whether additional sanctions are appropriate.

D. Deadlines. Deadlines for procedural dates shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday, the next business day shall be considered to be the last day. For good cause shown, the Staff may extend any of the procedural dates relating to the undertakings.

V.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in MCR’s Offer.

Accordingly, pursuant to Sections 15E(d), 21B and 21C of the Exchange Act, it is hereby ORDERED that:

A. MCR shall cease and desist from committing or causing any violations and any future violations of Section 15E(h)(1) of the Exchange Act and Rule 17g-5(c)(8)(i) thereunder;

B. MCR is hereby censured; and

C. MCR shall, within thirty (30) days of the entry of this Order, pay a civil money penalty in the amount of \$3,500,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717.

Payment must be made in one of the following ways:

(1) MCR may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

- (2) MCR may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) MCR may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying MCR as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Celia Moore, Assistant Regional Director, U.S. Securities and Exchange Commission, Boston Regional Office, 33 Arch St., 24th Fl., Boston, MA 02110.

D. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, MCR agrees that in any Related Investor Action, it shall not argue that it is entitled to, nor shall it benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, MCR agrees that it shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against MCR by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

E. MCR shall comply with the undertakings enumerated in Section IV, above.

By the Commission.

Vanessa A. Countryman
Secretary