

December 31, 2013

Via Email

Commissioner Luis A. Aguilar  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Re: Request for Extension of Order Granting Temporary Exemption of Kroll Bond Rating Agency, Inc. from the Conflict of Interest Prohibition in Rule 17g-5(c)(1) of the Securities and Exchange Act of 1934 (SEC Rel. No. 34-65339, dated September 14, 2011)(the "Order")

Dear Commissioner Aguilar:

By letter dated November 19, 2013, Kroll Bond Rating Agency, Inc. ("KBRA"), a nationally recognized statistical rating organization ("NRSRO"), requested an extension of the Order, which provides an exemption from the above-referenced rule (the "10% Rule"). This letter is provided to supply additional information you requested.

As noted in the November 19 letter, KBRA has successfully grown its revenues primarily through the ratings of transactions involving the issuance of commercial mortgage-backed securities ("CMBS"). In 2013, CMBS ratings business accounted for over 75% of total net revenues. However, KBRA intends to become a full-service agency with rating capabilities covering all sectors of the capital markets. As it grows, KBRA's revenues will increasingly derive from ratings of a diversified group of issuers, rather than CMBS structured finance transactions. For example, in the 4<sup>th</sup> Quarter of 2013, approximately 37% of revenue came from sources other than CMBS. KBRA expects that by 2015, CMBS transactions will account for less than 50% of its total net revenues, and no single entity will provide more than 10% of the total.

Specifically, KBRA believes that it can build on its successes to date in ratings of municipal issuers, financial institutions and other corporate and project finance-related securities, while expanding the breadth of its structured finance business by increasing its presence in the asset-backed and residential mortgage-backed securities businesses as those sectors continue to recover.

Some particular 2013 landmarks are worth noting. First, KBRA published its methodology for rating, and its first ratings, of financial guarantors, which include monoline insurers that provide insurance to municipal and other public sector issuers. Such ratings entail performing ratings analyses on municipalities that the monolines insure. KBRA believes that the growth of this area will not only enhance current revenue, but will also facilitate the growth of KBRA's broader public finance ratings business. Second, KBRA rated one of the first "Real Estate Owned

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(REO)-to-Rental” transactions, which KBRA views as a significant step in the continued recovery of the housing market. The fact that KBRA has won acceptance in this business line will be a key element of diversification of revenue sources. Third, KBRA has achieved substantial growth in consumer and commercial asset-backed securities in a variety of areas, such as autos, container shipping and aerospace. Lastly, KBRA more than doubled the number of ratings provided in the project finance area. While these ratings are “private” (i.e., unpublished), such deals are contingent on satisfying the requirements of institutional investors, and thus reflect the acceptance of KBRA as a solid credit rating agency by our most important constituency – investors.

KBRA’s results to date give us confidence that our projections can be met: year over year revenue from 2011 to 2012 was up 312%; from 2012 to 2013, up 150%; and at present, increases of 62% from 2013 to 2014, and 50% from 2014 to 2015, are forecast.

What is worth reiterating is that 2013 saw the beginnings of real growth in certain areas – particularly public finance and financial guarantors – that are based on ratings of *issuers*, rather than being limited to *transactions*. In the context of the 10% Rule, transaction-based business makes for difficulties in projecting which institutions may be involved. Having a greater number of issuer ratings in the revenue mix will help buffer the effect that a handful of large transactions could have.

KBRA believes that it can compete successfully with the current players in the credit rating business, and will continue to provide a new voice that investors can trust. As stated in the November 19 letter, KBRA is confident that the requested relief will enable the continued growth of its business, and that if given additional time, KBRA will be able to operate under the 10% Rule without the need for an exemption.

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We understand that this letter may be attached to a private or public statement made by Commissioner Aguilar regarding the approval of the exemption request. If you have any questions regarding this letter, or if there is any further information that you may require, please do not hesitate to contact me by phone at (646) 731-2344, or by e-mail at [ajunnarkar@kbra.com](mailto:ajunnarkar@kbra.com).

Sincerely,



Ajay Junnarkar  
Chief Financial Officer

cc: Jules Kroll                      Thomas J. Butler  
James Nadler                      Harriet Orol  
Thomas R. Rus



**CONFIDENTIAL TREATMENT REQUESTED**

November 19, 2013

**Via Overnight Mail**

Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Re: Request for Extension of Order Granting Temporary Exemption of Kroll Bond Rating Agency, Inc. from the Conflict of Interest Prohibition in Rule 17g-5(c)(1) of the Securities and Exchange Act of 1934 (SEC Rel. No. 34-65339, dated September 14, 2011)(the "Order")

Dear Ms. Murphy:

Kroll Bond Rating Agency, Inc. ("KBRA"), a nationally recognized statistical rating organization ("NRSRO"), is submitting this letter pursuant to Section 36 of the Securities Exchange Act of 1934 (the "Exchange Act"), to request that the Commission provide to KBRA an extension of the temporary exemption from Exchange Act Rule 17g-5(c)(1) granted under the Order.

**Background**

As noted in its application for the Order, KBRA acquired LACE Financial Corporation ("LACE"), an NRSRO, in August 2010. At the time of acquisition, the rating business was based in Frederick, Maryland and was limited to the provision of ratings to subscribers. The business plan implemented following the acquisition entailed developing an issuer-paid business based in New York City, and growing both the subscription and issuer-paid businesses.

KBRA was aware that the issuer-paid business could potentially generate fees in a single transaction that would be significant relative to the fees generated annually by the subscription rating business. Accordingly, KBRA applied for relief from Exchange Act Rule 17g-5(c)(1) (the "Ten Percent Rule" or "Rule") and, on September 14, 2011, the Commission granted the Order.<sup>1</sup>

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<sup>1</sup> By its terms, the Order extended until January 1, 2013. As discussed below, the predicate for whether there is a violation of the Ten Percent Rule is established by reference to the total net revenue through December 31 each year. Accordingly, (i) throughout 2013, the prohibition on issuing or maintaining ratings solicited by a person who had provided more than 10% of total net revenue (which would use year-end 2012 total net revenue) does not apply, and (ii) the first point in time at which KBRA will be required to apply the 10% limit calculation/test is January 1,

For the reasons set forth below, including the promotion of competition in the credit rating industry,<sup>2</sup> KBRA respectfully requests an extension of the limited, conditional, temporary relief provided in the Order. The sections that follow describe how the conditions of the Order have been met, as well as providing factual background on KBRA's growth to date, and setting forth the reasons that an extension of the relief will serve to promote the interests of investors by promoting competition in the industry.

Conditions of the Order.

The Order states that the relief is conditioned on: (1) disclosure by KBRA in Exhibit 6 of Form NRSRO that the firm received more than 10% of its total net revenue in fiscal year 2011 or 2012 from a client or clients; and (2) implementation by KBRA of policies, procedures, and internal controls specifically designed to address the conflict created by exceeding the 10% threshold.

Disclosure. In accordance with the first of the conditions, KBRA amended Exhibit 6 of its Form NRSRO to provide disclosure to address the requirement in the Order.<sup>3</sup>

Policies, Procedures and Controls. To address the second condition, KBRA has adopted policies, procedures, and internal controls specifically designed to address the potential conflict created by exceeding the 10% threshold. The principal relevant policies, procedures and internal controls that have been implemented by KBRA are as follows:

1. *New Issuer-Paid Business Acceptance:* new issuer-paid business is subject to review by a Business Acceptance Committee (which excludes credit rating personnel) that considers a number of factors, including whether the engagement would create a conflict. Among the conflicts considered is whether the issuer provided 10% or more of total net revenue in the prior year, or will provide 10% or more of the projected total in the current year. A sign-off form is used which requires the Chief Financial Officer ("CFO") to make a calculation, based on expected revenue from the new engagement, to alert the Committee to a potential issue under the Ten Percent Rule.
2. *Policy prohibiting ratings analysts from discussing fees:* The firm's rating analyst function is segregated from the marketing function, including an absolute prohibition on

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2014 (using revenue earned through 2013 as the "denominator" for the 10% calculation). This interpretation of the Order – and in particular, the duration of the relief – was confirmed in a conversation with Randall Roy and Ray Lombardo on September 6, 2012. KBRA has therefore operated under the benefit of the Order from the time it was issued to the present.

<sup>2</sup> Congress stated in its findings to the Credit Rating Agency Reform Act of 2006 (the "Act") that "credit rating agencies are of national importance" and that, because the two largest credit rating agencies serve the vast majority of the market, "additional competition is in the public interest." Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327.

<sup>3</sup> KBRA's Exhibit 6 currently states in pertinent part: "KBRA received more than 10% of its net revenue in prior fiscal years from one or more clients that paid it to rate asset-backed securities, and may receive more than 10% of total net revenue from one or more such clients in the current fiscal year."

any discussion of fees by ratings personnel with marketing personnel. This prohibition is designed to mitigate the ability of an issuer to influence ratings personnel, which KBRA views as the policy goal of the Ten Percent Rule.

3. *Certification by senior rating officer:* At the time a final rating is issued, a senior rating officer must certify that to his or her knowledge, no ratings personnel will have negotiated, discussed or arranged the fee for the rating. Moreover, the signing analyst must also certify that the rating was based solely upon the merits of the security being rated, and no part of the rating was influenced by any other *business* activities of KBRA.
4. *Compliance monitoring:* KBRA Compliance receives a report from the CFO at least quarterly that includes information on (1) revenues from each issuer-paid client, and (2) the firm's total net revenues through the most recently ended year-to-date period. Compliance compares these figures, and reports instances where the issuance or maintenance of a rating would have resulted in a violation of the Ten Percent Rule, but for the Order. This information is included in a report submitted to executive management and the Board of Directors.
5. *Board oversight:* At quarterly meetings of the Board of Directors, the agenda includes a review of information regarding issuers that provide significant revenue to KBRA, and could potentially provide 10% or more of the firm's total revenue for the year. The Board discusses with management the actual or potential conflicts that may result from any such relationship.

These policies, procedures and controls have been the subject of review by the SEC's examination staff from 2010 to the present. Based on comments and recommendations received from examiners, and on management's assessment of the potential conflicts and the countervailing controls, KBRA management believes that this condition of the Order has been met.

#### Growth of KBRA Business and Revenue

Business Plan. KBRA's intention has been and continues to be to become a full-service agency with rating capabilities covering all sectors of the capital markets. As a means of executing this plan to grow its rating business, over the past 30 months, KBRA has aggressively hired experienced rating analysts and support staff, with a view to creating the ability to opportunistically enter new areas.

Much of the initial hiring was concentrated in developing the structured finance capabilities of the firm. It was the view of management that the damage to investor portfolios from the financial crisis of 2008 was caused in great measure by the incumbent rating agencies, and that portfolio losses (and the corresponding rating agency failures) were most sharply felt in the structured finance area. From its 2010 vantage point, management also believed that the real estate markets would recover relatively rapidly. Thus, the recovery and ascent of real estate markets, combined with residual concerns – or mistrust – of incumbent rating agencies would provide a unique opportunity for growth.

Analysis of Revenue Trends. KBRA's commercial mortgage-backed securities ("CMBS") rating business grew rapidly throughout 2011 and 2012, and has continued to expand in 2013. By comparison, the business of rating residential mortgage-backed securities ("RMBS") has developed slowly, due to the fitful recovery of the U.S. residential real estate market through this period. Other areas of expected rating business growth, such as asset-backed securities ("ABS"), public finance and financial institutions, have gained a foothold and have grown, but at a much more modest pace than the CMBS business.

The broad-based and rapid revenue growth that is made compulsory by the Ten Percent Rule has also been hindered by institutional inertia. Corporate inertia can take various forms. An example is the use by institutional investors of investment guidelines that limit permitted investments to those instruments that have been rated by a specific rating agency – usually one or another of the well-established incumbents, i.e., Moody's, S&P or Fitch. This is reinforced through positions taken by certain regulatory authorities. For example, insurance companies must invest within guidelines promulgated by the National Association of Insurance Commissioners ("NAIC") in order to get favorable treatment under statutory accounting rules.<sup>4</sup> KBRA applied for the requisite NAIC status in 2011, but was not added to the formal NAIC list until July 1, 2012. A similar impediment existed until recently with respect to employee benefit plans that are subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). Until July 2013, plans evaluating investments were required to select securities rated by one of four rating agencies named in DOL Prohibited Transaction Exemptions. A change was adopted that broadens the scope of the exemption to include all NRSROs that meet certain conditions; but the means by which plan fiduciaries must verify an NRSRO's adherence to those conditions is still a matter of industry discussion.<sup>5</sup>

In sum, since 2011, KBRA's growth has been limited by a number of external factors, with rapid revenue growth coming almost exclusively through CMBS ratings. It is noteworthy that the 10 largest global CMBS book-runners accounted for over 92% of the total CMBS market share during 2012.<sup>6</sup> This reflects the fact that the universe of CMBS issuers is relatively small. Thus, while KBRA was fairly evenly represented among these large arrangers, the consequence of the universe of arrangers being small (and the rate of growth of non-CMBS areas being modest) was that each CMBS arranger provided a significant percentage of total net revenue during 2011 and 2012.

As a result of the comparatively slow growth in other areas, \_\_\_% of KBRA's total net revenue for 2012 was sourced from CMBS ratings. To bar further engagements from the limited number of firms that act as CMBS arrangers would not only cause significant harm by virtue of eliminating those firms as sources of future revenue, it would potentially harm KBRA's

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<sup>4</sup> Specifically, insurers must invest in securities given certain ratings by a rating agency that is a "credit rating provider," as designated by the NAIC's Securities Valuations Office. See <http://www.naic.org/svo.htm>.

<sup>5</sup> Department of Labor, Notice of Exemption from Certain Prohibited Transaction Restrictions, 78 Fed. Reg. 41090 (July 9, 2013).

<sup>6</sup> See *Commercial Mortgage Alert*, January 11, 2013, p. 34.

credibility in the small and essentially closed universe of CMBS firms, and jeopardize its ability to continue doing business in that crucial sector.

In 2013, total year-to-date net revenue through September 30 has followed a similar track, in that the majority (\_\_\_ %) is sourced from CMBS. Looking forward, we are encouraged by business development in other sectors, so we expect to see more diversification of revenue sources over time. However, KBRA's optimism is tempered by the possibility that a rising interest rate environment could dampen the market appetite for issuance of new bonds, leaving diminished opportunities for new revenue.

### Regulatory Analysis

When the Commission adopted the Ten Percent Rule, it noted that it intended to monitor how the prohibition operates in practice, particularly with respect to asset-backed securities, and whether exemptions may be appropriate. The Commission has noted that activities that exceed the threshold set in the Ten Percent Rule may or may not necessarily raise the concerns that are the basis for the rule and has granted exemptions from the Rule on a case-by-case basis.<sup>7</sup>

Since the inception of its issuer-paid business, KBRA has adopted and maintains policies and procedures that we believe are effective at preventing the type of undue influence that is contemplated by the Rule. As noted, these policies and procedures have been and will continue to be the subject of examination, which will reaffirm their continued effectiveness.

Given the continued view that credit rating agencies are "central to capital formation, investor confidence, and the efficient performance of the U.S. economy,"<sup>8</sup> and in light of the continued need to foster competition in the credit rating business, KBRA believes that extension of the Order will continue to be of benefit to investors and the marketplace overall.

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### Request for Relief

In summary, the reasons for granting the requested relief are that:

- The Order serves to foster competition in the ratings industry, which is in the public interest and, specifically, in the interest of investors and financial markets;
- KBRA has met and will continue to meet all of the conditions set forth in the Order; and

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<sup>7</sup> See Order Granting Temporary Exemption of Realpoint LLC From the Conflict of Interest Prohibition, SEC Release No. 34-58001, 73 Fed. Reg. 36362 (June 26, 2008) (noting that because activities that exceed the 10% threshold may not necessarily raise the concerns that are the basis for the rule, it is important for the Commission to consider the specific facts and circumstances of each applicant seeking exemption).

<sup>8</sup> Mary Jo White, Chairman, U.S. Sec. & Exch. Comm'n, Opening Remarks at SEC Roundtable on Credit Ratings (May 14, 2013).

- KBRA believes that the relief will enable the continued growth of its business, consistent with the intent of Congress, as stated in the Act, and that if given additional time, KBRA will be able to operate under the Ten Percent Rule without the need for an exemption.

Accordingly, we respectfully request that the Commission extend the relief granted to KBRA under the Order, by modifying the Order so that it is in effect until January 1, 2015.

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If you have any questions regarding this letter, or if there is any further information that you may require, please do not hesitate to contact me by phone at (240) 394-4138, or by e-mail at [trus@krollbondratings.com](mailto:trus@krollbondratings.com).

Sincerely,



Thomas R. Rus  
Vice President and Chief  
Compliance Officer

Enclosures

cc: Jules Kroll	Thomas J. Butler
James Nadler	Harriet Orol
Ajay Junnarkar	Annemarie Ettinger
Angela Liang	Randall Roy