
**2012 SUMMARY REPORT OF COMMISSION STAFF'S EXAMINATIONS OF
EACH NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION**

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.**

November 2012

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I. REGULATORY AND NRSRO OVERVIEW

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”).¹ 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 public this Staff report as required by Section 15E(p)(3)(C) of the Exchange Act.

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.² The Rating Agency Reform Act added Section 15E to the Exchange Act, which established Commission oversight of 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.³

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 Rules 17g-1 through 17g-6 and Form NRSRO to implement the registration and oversight program created 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 certain 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 unfair, coercive, or abusive practices, and enhancing NRSRO record keeping.

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

¹ 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.

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

³ *See* Sections 17(a) and 17(b).

requirements.⁴ The Dodd-Frank Act directs the Commission to adopt rules to implement a number of provisions related to NRSROs. In January 2011, the Commission adopted new Rule 17g-7.⁵ In addition, the Commission has proposed new rules to implement certain provisions of the Dodd-Frank Act concerning the following areas:

- Filing annual reports on internal controls;⁶
- Addressing conflicts of interest with respect to sales and marketing concerns;⁷
- 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;⁸
- Disclosing information relating to initial credit ratings and subsequent changes to credit ratings to track the performance of an NRSRO’s credit ratings;⁹
- Requiring an NRSRO to have certain policies and procedures governing the way an NRSRO determines credit ratings;¹⁰
- Publishing a standard form with each credit rating disclosing, among other things, the assumptions underlying the methodology used to determine the credit rating;¹¹
- Disclosing information concerning third-party due diligence reports for asset-backed securities;¹²
- Establishing professional standards for training credit rating analysts;¹³ and
- Requiring the consistent application of rating symbols and definitions.¹⁴

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

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

⁵ See Exchange Act Release No. 33-9175 (Jan. 20, 2011), 76 FR 4489 (Jan. 26, 2011). 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.

⁶ Section 15E(c)(3)(B).

⁷ Section 15E(h)(3)(A).

⁸ Section 15E(h)(4)(A).

⁹ Section 15E(q)(1).

¹⁰ Section 15E(r).

¹¹ Section 15E(s)(1).

¹² Section 15E(s)(4)(C).

¹³ Dodd-Frank, § 936, 124 Stat. 1884-85.

¹⁴ Dodd-Frank, § 938(a), 124 Stat. 1376, 1885.

Exchange Act Rules Applicable to NRSROs	
Rule 17g-1	Requires a credit rating agency 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 certain audited and unaudited annual financial reports and reports of the number of credit rating actions with the Commission.
Rule 17g-4	Requires an NRSRO to establish and enforce written policies and procedures designed to address specific areas in which material, non-public 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.

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.¹⁵

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"). The credit rating agencies registered as NRSROs as of November 1, 2012, and the dates of their initial registration, are listed below:¹⁶

NRSRO ¹⁷	Date of Registration
A.M. Best Company, Inc. ("A.M. Best")	September 24, 2007
DBRS, Inc. ("DBRS")	September 24, 2007
Egan-Jones Ratings Company ("EJR")	December 21, 2007
Fitch, Inc. ("Fitch")	September 24, 2007
Japan Credit Rating Agency, Ltd. ("JCR")	September 24, 2007
Kroll Bond Rating Agency, Inc. ("KBRA") ¹⁸	February 11, 2008
Moody's Investors Service, Inc. ("Moody's")	September 24, 2007
Morningstar Credit Ratings, LLC ("Morningstar") ¹⁹	June 23, 2008
Standard & Poor's Ratings Services ("S&P")	September 24, 2007

The table below provides the number of outstanding credit ratings reported by each NRSRO, in its annual certification for the calendar year ending December 31, 2011, in each of the five categories identified in Section 3(a)(62) of the Exchange Act for which the NRSRO is registered.

¹⁵ Section 15E(p)(3)(C)(i)-(iii).

¹⁶ On October 13, 2011, Rating and Investment Information, Inc., which had been registered with the Commission as an NRSRO since September 24, 2007, furnished the Commission with a notice of withdrawal from registration as an NRSRO. The withdrawal became effective on November 27, 2011. See <http://www.sec.gov/news/digest/2011/dig112811.htm>.

¹⁷ Orders granting registration can be found at: <http://www.sec.gov/about/offices/ocr.shtml>. In addition, each NRSRO is required to post its Form NRSRO and Exhibits 1 through 9 on its own website.

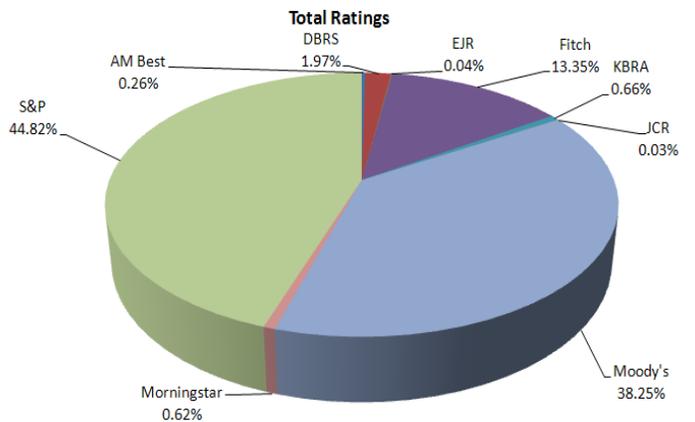
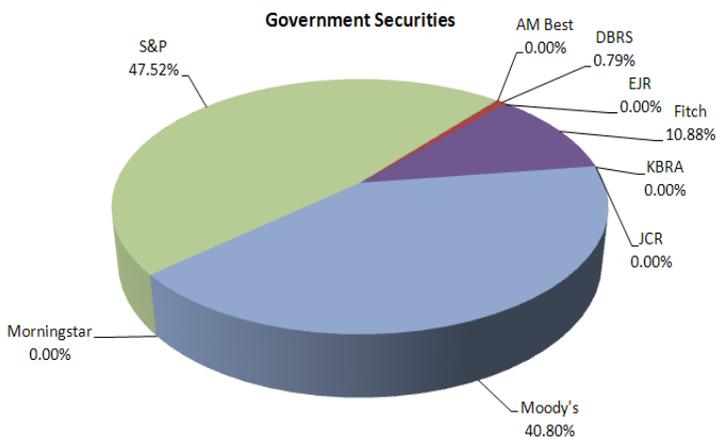
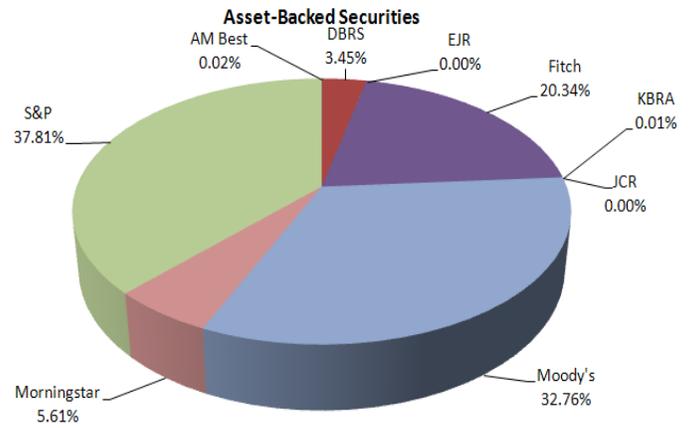
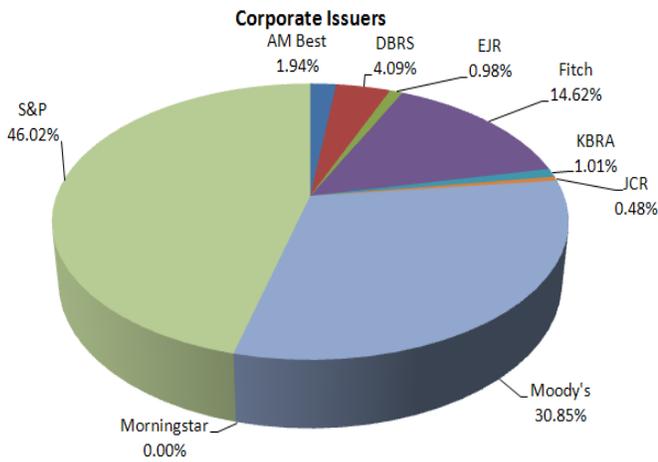
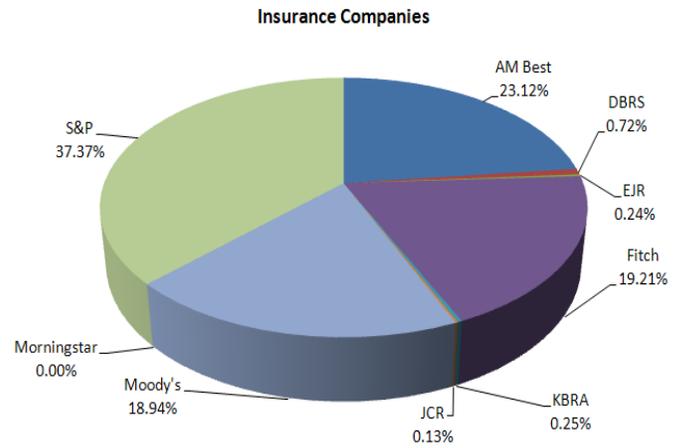
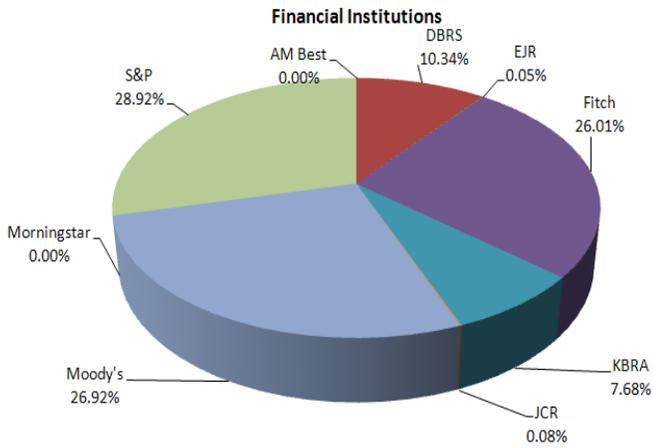
¹⁸ Formerly known as LACE Financial Corp.

¹⁹ Formerly known as Realpoint LLC.

Number of Outstanding Credit Ratings by Category of Credit Rating						
Source: NRSRO Annual Certifications for the Year Ended December 31, 2011						
NRSRO	Financial Institutions	Insurance Companies	Corporate Issuers	Asset-Backed Securities	Government Securities	Total Ratings
A.M. Best	N/R	4,826	1,910	56	N/R	6,792
DBRS	21,695	151	4,037	9,889	15,798	51,570
EJR	101	51	962	13	9	1,136
Fitch	54,586	4,010	14,427	58,315	217,198	348,536
JCR	163	27	478	N/R	54	722
KBRA	16,127	52	1,001	40	58	17,278
Moody's	56,486	3,953	30,439	93,913	814,087	998,878
Morningstar	N/R	N/R	N/R	16,070	N/R	16,070
S&P	60,700	7,800	45,400	108,400	948,300	1,170,600
Total	209,858	20,870	98,654	286,696	1,995,504	2,611,582

*N/R indicates the NRSRO is not registered for that category of securities.

The pie charts below depict the percent of the credit ratings in total and in each category reported by all NRSROs as of December 31, 2011 that were attributable to each NRSRO. For example, per the above table, A.M. Best reported that it had 4,826 insurance company credit ratings, and the total of the credit ratings in that category reported by all NRSROs was 20,870. Dividing 4,826 by 20,870 = (approximately) 0.2312 or 23.12% (the proportion of NRSRO insurance company ratings attributable to A.M. Best).



Moody's and S&P were the two largest NRSROs based on the number of credit ratings as of December 31, 2011, with approximately 1 million and 1.2 million ratings, respectively, and Fitch was the third largest with approximately 350,000 ratings. However, concentration was not consistent across rating classes. Moody's and S&P had the largest number of credit ratings of corporate issuers, asset-backed securities, and government securities. For credit ratings of financial institutions, Fitch and Moody's had substantially more ratings than S&P in the past. The gap narrowed in 2010 and, in 2011, S&P surpassed Fitch and Moody's in this class. Also in 2011, S&P had the largest number of credit ratings of insurance companies, with A.M. Best, Fitch, and Moody's providing most of the remaining ratings in that class.

Two NRSROs, Moody's and S&P, accounted for approximately 83% of all credit ratings. Moody's, Fitch, and S&P accounted for approximately 96% of all credit ratings (the top three accounted for 97% of all outstanding credit ratings in last year's report). The concentration of ratings for these three NRSROs is high across all five categories but varies across those categories. For instance, Fitch, Moody's, and S&P account for over 99% of all NRSRO ratings for government, municipal and sovereign securities,²⁰ but approximately 75% of all NRSRO ratings for insurance companies.²¹ For various reasons, including those discussed below, market concentration must be considered together with other factors to identify the level of competition in a given market.

Some of the smaller NRSROs concentrate more on particular sectors or regions. For example, A.M. Best primarily rates insurance companies. Morningstar rates only asset-backed securities. KBRA has historically focused on rating financial institutions, although recently it has started to expand into other areas. JCR is based in Japan and issues ratings primarily on Japanese issuers and securities.

Among the smaller NRSROs, KBRA and DBRS reported having the largest number of ratings of financial institutions (16,127 and 21,695, respectively, or approximately 8% and 10%, respectively, of all ratings in this category). A.M. Best reported the largest number of ratings of insurance companies among the smaller NRSROs (4,826, or about 23%, of all ratings in this category) and DBRS reported the largest number of ratings of corporate issuers among the smaller NRSROs (4,037, or about 4% of all ratings in this category).

Of the 286,696 credit ratings of asset-backed securities, all but 26,068 (approximately 9%) were attributable to Fitch, Moody's, and S&P. Among the smaller NRSROs, Morningstar reported having the largest number of ratings of asset-backed securities (16,070, or approximately 6%, of all ratings in this category).

²⁰ Fitch, Moody's, and S&P together accounted for 1,979,585 of the 1,995,504 outstanding NRSRO credit ratings in this category as of December 31, 2011.

²¹ Fitch, Moody's, and S&P together accounted for 15,763 of the 20,870 outstanding NRSRO credit ratings in this category as of December 31, 2011.

Six of the NRSROs operate primarily under the “issuer-pay” model.²² Two of the NRSROs, KBRA and Morningstar, previously operated primarily under the “subscriber-pay” model but in recent years have begun issuing ratings under the issuer-pay model.²³ Only EJR operates fully under the subscriber-pay model. The NRSROs operating primarily under the issuer-pay model account for almost 99% of the total NRSRO credit ratings reported by NRSROs as of December 31, 2011.

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

Number of Credit Analysts and Credit Analyst Supervisors*			
	Credit Analysts	Credit Analyst Supervisors	Total
A.M. Best	82	41	123
DBRS	84	34	118
EJR	2	3	5
Fitch	758	338	1,096
JCR	24	33	57
KBRA	22	6	28
Moody's	1,124	128	1,252
Morningstar	26	10	36
S&P	1,172	244	1,416

* As reported by each NRSRO on Exhibit 8 of Form NRSRO, for year-end 2011.

II. OFFICE OF CREDIT RATINGS AND EXAMINATION OVERVIEW

As required by Section 15E(p)(1), the Commission established the Office of Credit Ratings (“OCR”) in June 2012 with the appointment of Director Thomas Butler. OCR has conducted the 2012 annual NRSRO examinations.

A. Examinations under Section 15E(p)(3)

Section 15E(p)(3)(A) requires OCR to conduct an examination of each NRSRO at least annually. Prior to the formation of OCR, examinations of NRSROs were conducted by the Commission’s Office of Compliance Inspections and Examinations. This Report was prepared by Staff of the NRSRO examination program within OCR.

²² A.M. Best, DBRS, Fitch, JCR, Moody’s, and S&P.

²³ See Exhibit 2 to KBRA’s Form NRSRO, as of its annual certification dated March 30, 2012, in which KBRA states that it offers issuer-paid ratings as well as subscriptions to its ratings and describes its process for determining each type of rating; See also Exhibit 2 to Morningstar’s Form NRSRO, as of its annual certification dated March 31, 2012, in which Morningstar states that it generally issues ratings either as a rating agency selected and paid by the arranger or as a non-selected rating agency providing a final rating and surveillance to subscribers on a subscription-pay basis.

Section 15E(p)(3)(B) requires that the examination shall include a review of: (i) whether the NRSRO conducts business in accordance with the policies, procedures, and rating methodologies of the NRSRO; (ii) the management of conflicts of interest by the NRSRO; (iii) implementation of ethics policies by the NRSRO; (iv) the internal supervisory controls of the NRSRO; (v) the governance of the NRSRO; (vi) the activities of the designated compliance officer (“DCO”) of the NRSRO; (vii) the processing of complaints by the NRSRO; and (viii) the policies of the NRSRO governing the post-employment activities of former staff of the NRSRO.

Section 15E(p)(3)(C) requires the Commission to “make available to the public, in an easily understandable format, an annual report summarizing—(i) the essential findings of all examinations conducted under Section 15E(p)(3)(A), as deemed appropriate by the Commission; (ii) the responses by the NRSROs to any material regulatory deficiencies identified by the Commission under clause (i); and (iii) whether the NRSROs have appropriately addressed the recommendations of the Commission contained in previous reports under Section 15E(p)(3).”

B. Examination Overview

The 2012 Section 15E examinations (“2012 examinations”) began in October 2011. The 2012 examinations generally focused on NRSRO activities for the period covering August 1, 2010 through September 30, 2011 (the “Review Period”).

The 2012 examinations included a review of the eight areas enumerated in Section 15E(p)(3)(B) and examined how each NRSRO adhered to Section 15E and Commission Rules 17g-1 through 17g-7.

For clarity, this Report will refer to Fitch, Moody’s, and S&P as the larger NRSROs. The six other NRSROs (A.M. Best, DBRS, EJR, JCR, KBRA, and Morningstar) will be referred to as the smaller NRSROs. One smaller NRSRO that was discussed in the *2011 Summary Report of Commission Staff’s Examinations of Each Nationally Recognized Statistical Rating Agency* (“2011 Summary Report”), Rating & Investment Information Inc., withdrew from registration during the Review Period and therefore is not discussed in this Report.

III. PUBLIC ADMINISTRATIVE PROCEEDING

In April 2012, the Commission’s Division of Enforcement instituted administrative proceedings against EJR and Sean Egan, EJR’s founder, President, owner, and primary analyst.²⁴ In the Order Instituting Proceedings (“OIP”), the Division of Enforcement alleges that EJR and Mr. Egan committed numerous violations of Sections 15E and 17(a) and the rules thereunder. The OIP specifically alleges that EJR made material misrepresentations and omissions in its initial application for NRSRO status and its annual certifications, including overstating EJR’s qualifications with respect to rating asset-backed securities and government securities and

²⁴ *In the Matter of Egan-Jones Ratings Company and Sean Egan*, Release No. 66854 (April 24, 2012).

inaccurately stating that EJR was not aware of its subscribers' holdings. The OIP also alleges that EJR failed to adequately disclose and manage conflicts of interest related to securities ownership by its employees, and in several instances EJR analysts participated in determining credit ratings of issuers in which they owned securities. Finally, the OIP alleges that EJR failed to make and retain records documenting the established procedures and methodologies it uses to determine credit ratings, as well as required records concerning the basis for its credit rating actions, the identity of personnel that participated in each credit rating action, whether the rating action was solicited or unsolicited, and certain types of communications concerning each credit rating.

The Commission's administrative proceeding is pending, with a hearing currently scheduled for later in 2012.

In June 2012, EJR and Mr. Egan filed a complaint in Federal District Court seeking to have the Commission's administrative proceeding removed to Federal Court.²⁵ The Federal District Court case is also pending.

IV. RESPONSES TO RECOMMENDATIONS FROM PRIOR REPORTS

The Staff's assessment of whether an NRSRO has appropriately addressed a recommendation depends on the specific facts and circumstances of each recommendation and the reasonableness of the NRSRO's response.

The Staff's determination that an NRSRO appropriately addressed a recommendation does not constitute the Staff's endorsement of that NRSRO or its policies, procedures, or operations. In a future examination, the Staff may continue to review and make additional recommendations concerning the NRSRO or its policies, procedures, and operations related to a recommendation that was appropriately addressed, or to the general subject matter of that recommendation. The Staff's assessment of whether an NRSRO has appropriately addressed a recommendation reflects solely the Staff's view and does not necessarily reflect the views of the Commission.

Based on the Staff's 2012 examinations, the Staff has determined that except for one smaller NRSRO, all NRSROs appropriately addressed the Staff's recommendations contained in the 2011 Summary Report. This smaller NRSRO declined to formally respond to the Staff's recommendations from the 2011 examination of the NRSRO which were summarized in the 2011 Summary Report. Moreover, during the 2012 examination of this NRSRO, the Staff found that this smaller NRSRO failed to appropriately address the vast majority of recommendations from the 2011 examination and that its policies, procedures, and operations continue to raise most of the same concerns that the Staff identified during the 2011 examination.

²⁵ *Egan-Jones Rating Co. v. S.E.C.*, 2012-cv-00920 (D.D.C. June 6, 2012).

V. SUMMARY OF ESSENTIAL FINDINGS

Section 15E(p)(3)(C)(i) requires this Report to contain a summary of the essential findings of the annual examinations, as deemed appropriate by the Commission.

For purposes of this Report, “essential findings” include the Staff’s most notable observations and concerns arising from the examinations. These essential findings are not findings of the Commission, and the Staff’s inclusion of an issue does not necessarily mean that the Staff has reached a definitive conclusion about that issue. Essential findings are organized according to the eight review areas set forth in Section 15E(p)(3)(B).

The Commission has not determined whether 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.

A. Review Area: 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. In addition, 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. These 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. The Staff employed a risk-based sampling process in selecting the files for review. The Staff’s reviews of the eight 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 regarding whether each NRSRO has conducted its business in accordance with policies, procedures and methodologies are as follows:

1. Each of the larger NRSROs and two of the smaller NRSROs did not appear to follow their methodologies and certain policies and procedures in determining certain credit ratings.

The Staff found that one of the larger NRSROs appears to have changed the method for calculating a key financial ratio in rating certain asset-backed securities, but failed for several months to publicly disclose the change and its effects on the ratings, and continued to incorrectly reference the previously used method in its published rating reports. It also failed to provide sufficient disclosure about the method used to calculate such ratio in its published rating methodology applicable to these securities. Further, it appears the NRSRO did not consistently apply its rating methodology and failed to follow certain internal rating policies and procedures

with respect to these securities, including the policy regarding the use of models, in assigning initial ratings to, and performing surveillance on, these asset-backed securities. The Staff found that this NRSRO appeared to have weak internal supervisory controls and lacked transparency over the process of rating these asset-backed securities. The Staff is also concerned that this NRSRO may have been influenced by market share and business considerations in its application of the methodology used to rate asset-backed securities.

The Staff found that two of the larger NRSROs did not appear to follow their respective methodologies and relevant policies and procedures in the rating of a certain financial institution. In rating such institution, the two NRSROs appeared not to have analyzed certain important factors in their respective methodologies.

The Staff identified one instance in which it appeared that a smaller NRSRO allowed an issuer to improperly influence the substance of its ratings press release. The Staff found that, after receiving a request from the issuer to re-characterize its opinion of the issuer's financial performance in its press release, the NRSRO did in fact alter the press release language referring to its opinion of the issuer's financial performance in contravention of its policies and procedures concerning the revision and publication of press releases. The Staff also found that the NRSRO did not appear to conduct the analyses and request the documents required by its policies and procedures when it issued a short-term investment grade rating of the same issuer, contrary to the NRSRO's own rating policies. Approximately two weeks after the NRSRO published these ratings and the press release, the issuer petitioned for bankruptcy.

The Staff found that one of the smaller NRSROs produced ratings that were not in accordance with its methodologies and rating processes.

The Staff recommended that each of the three larger and two smaller NRSROs ensure that their employees understand and adhere to their methodologies, policies, and procedures. The Staff also recommended that the relevant NRSROs conduct a review of their practices involving the application of their rating methodologies to ensure use of a consistent approach and publish updated methodologies as needed. Further, a recommendation was made to the relevant NRSROs to ensure that the models used for determining credit ratings are used in accordance with the NRSRO's policies and procedures.

2. One of the larger NRSROs and two of the smaller NRSROs appeared to have inadequately disclosed portions of their ratings methodology, or changes to such methodology.

The Staff found that one of the larger NRSROs appeared not to have adhered to its Code of Professional Conduct when, in some instances, it published and disclosed its methodologies in an inconsistent and less than transparent manner. Under Rule 17g-2(a)(6), an NRSRO is required to document the established methodologies used in determining credit ratings. The Staff observed that the NRSRO's practice of using different terms to refer to methodologies could make it difficult for users to find the most up-to-date and comprehensive methodology for a particular credit rating. In addition, the Staff found instances in which the NRSRO's methodologies did not link or refer to subsequent publications that supplemented and, in some cases, replaced

existing methodology. This NRSRO's Code states that it is the NRSRO's responsibility to be as transparent as practicable with respect to its rating methodologies.

One of the smaller NRSROs has not consistently updated and disclosed changes to certain asset-backed security rating methodologies. In the 2011 Section 15E examination, the Staff recommended that this NRSRO evaluate its internal controls to ensure that methodology changes are promptly applied to existing credit ratings in accordance with the NRSRO's policies and procedures. In this year's examination, the Staff found that although the NRSRO had applied the methodology changes to many of the affected ratings, the NRSRO had not completed applying the methodology changes to all of the affected credit ratings, in accordance with the timeline proposed by the NRSRO.

The second of the smaller NRSROs has not documented and published methodologies for several types of its ratings. This NRSRO has failed to adequately disclose its methodologies as required on Form NRSRO.

The Staff recommended that each of these NRSROs promptly disclose new and revised methodologies, and, as applicable, enhance their internal supervisory controls regarding such methodologies, in accordance with the applicable statutes, Commission rules, and its policies and procedures.

3. One of the larger NRSROs failed to adhere to policies and procedures by delaying certain rating actions and one of the larger NRSROs and two of the smaller NRSROs failed to adhere to policies and procedures or have unclear policies regarding the surveillance of existing credit ratings.

One of the larger NRSROs delayed downgrading a number of structured finance transactions in order, the Staff believes, to give the issuers or other relevant parties the opportunity to avoid downgrades by restructuring their transactions and in anticipation of regulatory action. The Staff found that the NRSRO placed certain European residential mortgage-backed securities tranches on watch for potential downgrades for over two years and failed to review the watch within the timetable specified in its policies. In doing so, the NRSRO failed to follow its policies and procedures with regard to the use of rating watch status and the timeliness of reviews conducted on the rating watch status. The NRSRO also failed to apply new criteria to these transactions within the time period required by its policies.

One of the other larger NRSROs requires analysts to be skeptical about information coming from corporate and governmental issuers but may not be giving analysts sufficient guidance as to the meaning or application of this surveillance procedure requirement. The Staff is also concerned that this NRSRO's surveillance analysts may be over relying on qualitative factors and personal opinions which may potentially result in a disregard for quantitative criteria factors and inconsistent rating analysis.

In the case of the two smaller NRSROs, both of the firms had inadequate policies and procedures governing the surveillance process and failed to conduct timely reviews of outstanding ratings in accordance with their surveillance policies and procedures.

The Staff recommended that each of these NRSROs enhance or follow its existing policies and procedures to ensure timely review of existing ratings in compliance with applicable policies and procedures and application of new criteria to existing ratings.

4. All of the NRSROs had weaknesses in record retention and recordation of rating actions and committee procedures.

The Staff found weaknesses in the NRSROs' record retention and recordation of rating actions and committee procedures. In examining samples of the NRSROs' rating files, the Staff found many of them to be missing certain documents, such as confidentiality statements to an issuer prior to a rating release, document checklists, committee memos, and communications records, as required by each NRSRO's record retention policies or Rule 17g-2. The Staff also found inaccuracies in vote tallies, records of committee attendances, and committee minutes in certain rating files. In some structured finance rating files, the Staff found incomplete rating recommendations relating to the final tranches and were unable to ascertain what the committee ultimately approved. In some instances, there was no rationale recorded for why the final rating recommendation deviated from the original.

One of the smaller NRSROs violated its committee policies and procedures when a rating committee made changes to the rating scale of a particular asset class and altered the procedure for assigning those ratings. Another smaller NRSRO did not maintain records required by Rule 17g-2 and its own policies and procedures including: the identity of analysts who participated in determining or approving the rating, whether the rating was solicited or unsolicited, sources of information that formed the basis of the credit rating, model outputs and differences between the rating implied by the model and the actual rating, and complete and accurate policies and procedures for the rating committee and rating committee minutes.

The Staff recommended that seven of the NRSROs retain all necessary records as required by Rule 17g-2 and their record retention policies and procedures and, for one larger NRSRO, that it maintain accurate and complete minute sheets for rating committees. In certain cases, the Staff also recommended that the NRSROs consider modifying or establishing policies and procedures for the retention of records used to form the basis of its credit ratings. Further, the Staff recommended that one of the smaller NRSROs ensure that its rating committees restrict themselves to the activities permitted under their rating policies and ensure that the basis of their rating decisions is properly recorded and maintained.

5. All of the NRSROs failed to follow their procedures in some instances and the Staff identified weaknesses in certain policies and procedures.

The Staff's ratings file review generally found other instances where each of the NRSROs failed to follow some of their procedures, in addition to other instances more specifically discussed in this Report. The Staff identified some weaknesses with certain policies and procedures relating to dissemination of ratings information. The Staff also found that some of the NRSROs' policies

did not accurately reflect current practices. One of the NRSROs did not have sufficient policies addressing Rule 17g-5(a)(3),²⁶ although it did maintain the password-protected website required by the rule. Some NRSROs did not have sufficient policies addressing Rule 17g-7, which concerns representations and warranties for asset-backed securities, although they appeared to be generating the required reports.

The Staff made various recommendations to the NRSROs which generally involved enhancing internal controls to ensure that policies and procedures are followed and strengthening policies and procedures where needed.

B. Review Area: Management of Conflicts of Interest

Section 15E(h)(1) requires an NRSRO to establish, maintain, and enforce written policies and procedures reasonably designed to address and manage conflicts of interest. The conflicts of interest must be disclosed in Exhibit 6 to Form NRSRO, and the written policies and procedures to address and manage these conflicts 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 prohibited.

The Staff's essential findings regarding management of conflicts of interest are as follows:

1. One of the smaller NRSROs had insufficient policies and procedures for a committee responsible for managing certain conflicts of interest.

One of the smaller NRSROs was granted a temporary exemption by the Commission related to Rule 17g-5(c)(1). The rule prohibits an NRSRO from issuing or maintaining a credit rating for an entity that contributed more than 10% of an NRSRO's net revenue in the most recently ended fiscal year. Under the exemption, the NRSRO is required to maintain "policies, procedures, and internal controls specifically designed to address the conflict created by exceeding the 10% threshold". The Staff found that the committee established by the NRSRO to manage this conflict lacked sufficiently detailed operating guidelines. In addition, the committee did not maintain minutes and only kept records approving the acceptance of an engagement. The Staff recommended that the NRSRO create detailed procedures for, and properly document, the work of this committee.

2. Two of the larger NRSROs and three of the smaller NRSROs did not fully disclose certain conflicts of interest or their related policies and procedures and may not have adequately managed certain conflicts of interest.

²⁶ This rule requires an NRSRO that is hired by an arranger to determine an initial credit rating for a structured finance product to take certain steps designed to allow an NRSRO that is not hired by the arranger to nonetheless determine an initial credit rating – and subsequently monitor that credit rating – for the structured finance product.

One of the larger NRSROs did not adequately disclose in Exhibit 7 of its Form NRSRO policies and procedures to manage conflicts of interest related to independent board members' securities ownership and business relationships with rated entities. The NRSRO has asserted that these conflicts are managed through the independent board members' appointment letters, but those letters are not referenced in Exhibit 7. Another larger NRSRO referred to the potential conflict of interest related to ratings of shareholders owning greater than 5% of the NRSRO's parent company in Exhibit 6 of its Form NRSRO but did not appear to have policies and procedures to manage such conflict.

Some potential conflicts of interest at one of the smaller NRSROs were not disclosed in Exhibit 6 of its Form NRSRO and the NRSRO did not appear to have policies and procedures to manage these conflicts. These included conflicts related to employees' outside business activities and information obtained through additional services offered by the NRSRO. A second smaller NRSRO failed to disclose in Exhibit 6 of its Form NRSRO the ability of certain employees to own securities or money market instruments rated by that NRSRO. Another smaller NRSRO had at least one conflict of interest that it did not disclose in Exhibit 6 of its Form NRSRO. Additionally this smaller NRSRO included the potential conflict of interest related to ratings of shareholders owning greater than 5% of the NRSRO in Exhibit 6 but did not appear to have considered whether to aggregate affiliates when determining this threshold to manage such conflict.

The Staff recommended that each of these NRSROs disclose all conflicts of interest and how those conflicts of interest are managed in Form NRSRO and ensure that it has adequate procedures to monitor compliance with, and enforce, the policies addressing conflicts of interest.

3. One of the larger NRSROs and one of the smaller NRSROs appeared to have weaknesses with respect to their policies and procedures for managing and monitoring the potential conflict of interest posed by employee securities ownership. Two other smaller NRSROs appeared to have some weaknesses with respect to their securities ownership policies and procedures.

Section 15E(h)(2)(C) requires an NRSRO to manage and disclose any conflicts of interest relating to business relationships, ownership interests, or any other financial or personal interest between an NRSRO, or employee, and a rated entity or its affiliate. Rule 17g-5(b)(6) requires that an NRSRO disclose and manage the conflict of interest that exists if it allows employees to directly own securities or money market instruments of, or have a direct ownership interest in, issuers or obligors subject to a credit rating determined by that NRSRO. In addition, Rule 17g-5(c)(2) prohibits an NRSRO from issuing or maintaining a rating with respect to an issuer or obligor where the: (i) NRSRO, (ii) a credit analyst that participated in determining a rating, or (iii) a person responsible for approving a rating, directly own, or have a direct ownership in, an issuer or obligor.

One of the larger NRSROs had policies which prohibit employees and their immediate family members from owning or transacting in securities of a rated entity on which the employee can reasonably expect to participate in determining or approving ratings. The policies generally require divestiture of such securities. The policies also contain limited exemptions under which

an employee may continue to hold such securities after receiving a recusal from conflicting ratings work. Notwithstanding the narrow scope of exemptions, this NRSRO approved a large number of recusals compared with a relatively small number of forced divestitures.

In the case of one of the smaller NRSROs, the securities ownership policies contain inconsistencies and certain weaknesses. In addition, it appeared that an analyst violated the policies and Rule 17g-5(c)(2) by owning securities issued by a company in which that analyst participated in rating actions. It also appeared that another employee held individual stocks in violation of the NRSRO's written policies.

The Staff also identified what appeared to be some weaknesses in two of the smaller NRSROs' securities ownership policies and procedures. These weaknesses involved instances where the policies may not be comprehensive. Periodic employee reporting requirements at a smaller NRSRO were not consistently met. Employees at another smaller NRSRO were not prohibited from trading in certain government securities while in possession of related material non-public information, and the NRSRO did not have a documented procedure to review requests by the DCO to trade securities.

The Staff made recommendations to each NRSRO, including that each NRSRO enhance and enforce its policies, procedures, and internal controls with respect to securities ownership and ensure full compliance with the required statutes and rules.

4. The Staff identified other areas where some NRSROs lacked certain conflict of interest policies and procedures or where such policies should be strengthened.

Rule 17g-5(a)(2) requires an NRSRO to establish, maintain and enforce written policies and procedures to address conflicts of interest. This includes conflicts of interest that involve persons within the NRSRO such as board members and conflicts that arise from providing ancillary services. Additionally, it includes conflicts referred to in Rule 17g-5(b)(4) and (5) relating to the payment for credit ratings by subscribers. Two of the larger NRSROs and one of the smaller NRSROs appeared to have weaknesses with respect to some of their policies and procedures for managing conflicts of interest involving certain board members in general or certain board members' activities. One of the larger NRSROs appeared to lack specific policies and procedures to manage the potential conflicts of interest involving persons who pay for subscriptions to receive or access the credit ratings of the NRSRO. One of the smaller NRSROs did not appear to have policies and procedures to manage the subscriber-pay potential conflict of interest and did not disclose this conflict until recently. The Staff made various recommendations to these NRSROs which involved implementing or revising policies and procedures to address the potential conflicts of interest.

Rule 17g-5(c)(6) prohibits an NRSRO from issuing or maintaining a credit rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings, or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models. One of the smaller NRSROs did not appear to have policies and procedures

governing the interaction between analytical staff and staff involved in fee discussions. The Staff recommended that the NRSRO enact policies and procedures governing the interaction between commercial and analytic staff regarding analytic product.

NRSROs must disclose the conflicts of interest arising from providing ancillary services and must maintain written policies and procedures to manage any such conflicts. Ancillary services consist of any services that an NRSRO may provide that are not related to the credit rating services. One of the smaller NRSROs appeared to have insufficient policies and procedures to manage conflicts of interest associated with such ancillary services. The Staff recommended that the NRSRO enhance and adhere to its policies, procedures, and internal controls to effectively manage the conflicts of interest related to its proxy business and adequately disclose them in Exhibit 7 of Form NRSRO.

C. Review Area: Implementation of Ethics Policies

Each NRSRO has implemented written ethics policies and procedures, and the Staff reviewed those policies and procedures and their implementation as part of the 2012 examinations. Much of the content of these policies and procedures address other related mandatory review areas under Section 15E(p)(3)(B). As such, to the extent that the Staff made essential findings related to the other mandatory review areas, those findings are addressed in other sections of this Report.

The Staff's essential findings regarding ethics policies and procedures are as follows:

1. The Staff found inconsistencies and weaknesses in the ethics policy of one of the smaller NRSROs. In addition this NRSRO's adherence to the ethics policy was inadequate.

One of the smaller NRSROs did not address the Staff's recommendation from the 2011 examination that it ensure its employees understand and comply with the NRSRO's ethics policy. Although all of the NRSRO's employees certified that they understood the ethics policy, it did not appear to the Staff that the employees understood the policy. Further, the NRSRO did not provide training to its employees on the policy. Also, the Staff is concerned that the ethics policy is unclear in some areas and lacks consistency with the NRSRO's other policies and procedures and certain disclosures in the NRSRO's 2012 Form NRSRO. For instance, certain conflict of interest policies are not consistently reflected in the NRSRO's Code of Ethics.

The Staff recommended that the NRSRO ensure that its ethics policy, procedures, and Form NRSRO are consistent, that its personnel understand and comply with the ethics policy, and that it has sufficient resources to maintain adherence to the ethics policy.

D. Review Area: Internal Supervisory Controls

Section 15E(c)(3) requires that each NRSRO establish, maintain, enforce, and document an effective internal control structure governing the policies, procedures, and methodologies for determining credit ratings. The Staff reviewed each NRSRO's overall control structure, including the internal control structure related to determining credit ratings.

Section 15E(g)(1) requires an NRSRO to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information. Rule 17g-4(a)(3) provides that the written policies and procedures an NRSRO must establish, maintain, and enforce pursuant to Section 15E(g)(1) must include policies and procedures reasonably designed to prevent the inappropriate dissemination of pending credit rating actions within and outside the NRSRO.

The Staff's essential findings regarding internal supervisory controls are as follows:

1. The internal supervisory controls of one of the larger NRSROs exhibited weaknesses with respect to the NRSRO's information technology systems designed for the dissemination of credit ratings.

The Staff observed several instances where weaknesses in the information technology infrastructure and controls of one of the larger NRSROs may have contributed to errors in the dissemination of credit ratings and other related information. Such errors resulted in the release of material, non-public information, and market confusion. In response to the errors, the NRSRO retained the assistance of a consulting firm, which made a number of recommendations and established a new internal committee to provide oversight going forward. The Staff recommended that the NRSRO should continue to ensure that the new committee has adequate resources and managerial oversight to effectively fulfill its mission.

2. The supervisory controls governing one of the smaller NRSROs overall internal control structure for determining and maintaining ratings continue to be weak.

The Staff found that one of the smaller NRSROs made minimal changes to its policies, procedures and internal controls during the Review Period although the Staff made numerous recommendations in the 2011 Examination regarding policies and procedures pursuant to Section 15E(c)(3)(A). The Staff also found situations where the NRSRO was not following its written policies and procedures during the Review Period. The Staff had several concerns about the NRSRO's policies and procedures. Some policies and procedures did not satisfy regulatory requirements. Some provisions continue to be in draft form since the 2011 examination. Employees of this smaller NRSRO appear to have different understandings of the policies and procedures, and no training for employees regarding the policies and procedures was provided.

The Staff made a number of recommendations to this NRSRO including a recommendation that the NRSRO conduct a comprehensive review of its written policies, procedures, and methodologies to ensure they meet statutory and rule requirements. The Staff also recommended that the NRSRO establish, maintain, enforce, and document an effective internal control structure in compliance with Section 15E(c)(3)(A) to ensure that it issues, maintains, and publishes ratings in compliance with its policies, procedures, and methodologies.

3. At three of the smaller NRSROs, there were flaws in the firm's public disclosures.

In two of the smaller NRSROs, the Staff found that the NRSROs made incorrect or incomplete submissions in their Form NRSRO filings. Also, in two of the smaller NRSROs, the Staff found that the NRSROs did not adequately distinguish between the activities of the registered NRSRO and non-NRSRO affiliate, or adequately distinguish its ratings of asset classes for which they do not have NRSRO registration.

The Staff made recommendations to these NRSROs regarding enhancements to their disclosures and internal controls.

4. Three of the smaller NRSROs experienced occasional delays in the release and dissemination of pending ratings. Another smaller NRSRO lacked procedures to monitor the timeliness of dissemination.

Three smaller NRSROs experienced some delays between the determination of the rating actions and the publication of ratings. One of these smaller NRSROs not only experienced delays in the publication and dissemination of ratings but in some cases failed to publish and disseminate rating actions after they were determined. Another one of the smaller NRSROs lacked procedures to monitor the timeliness of rating action disseminations.

The Staff made recommendations to each of these four NRSROs to ensure prompt release and dissemination of rating actions in accordance with their policies.

5. One of the larger NRSROs did not timely update certain dependent ratings²⁷ when the related supporting rating changed.

One of the larger NRSROs had instances where certain dependent ratings were not updated on a timely basis when the related supporting rating changed. The Staff recommended that this NRSRO enhance its internal controls to ensure that dependent ratings are updated on a timely basis.

6. One of the larger NRSROs lacks adequate controls and transparency with respect to its process for interpretations of criteria.

The Staff noted that one of the larger NRSROs has not established written policies and procedures applicable to interpretations of criteria and has not publicly disclosed the distinction between an interpretation of criteria and a change in criteria. There appears to be a disagreement within the NRSRO as to the distinction between an interpretation of criteria and a change in criteria. The Staff recommended that the NRSRO establish written policies and procedures for interpretations of criteria, provide sufficient public disclosure with respect to the meaning of, and distinction between, an interpretation of criteria and a change in criteria, and conduct training on the policies, procedures and guidelines relating to interpretations of criteria.

²⁷ A dependent rating is a rating that is derived from or dependent upon, for example, an outstanding rating of an issuer, an obligor other than the issuer, or a credit enhancement provider.

7. 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. For some NRSROs, the Staff made recommendations in areas concerning insufficient staff or resources for internal controls; a lack of oversight over the determination of ratings; inadequate internal supervisory controls policies and procedures; and flaws in the controls governing upcoming rating actions and other material non-public information.

The Staff made various recommendations to the NRSROs regarding improvements.

E. Review Area: Governance

The Staff's 2012 examinations involved an analysis of the NRSROs' compliance with Section 15E(t), with particular focus on the oversight function performed by the NRSROs' boards and governing committees. The Staff's essential findings relating to the NRSROs' compliance with the governance provisions of Section 15E(t) are as follows:

1. The board of a larger NRSRO and a smaller NRSRO may not be actively exercising their oversight duties and neither NRSRO is maintaining sufficient records of board activity.

In the case of one larger NRSRO, although the board members appear to be generally involved in the oversight of the NRSRO, the Staff is concerned that the board members may not be actively engaged in advising NRSRO management on the issues relating to their required Section 15E(t)(3) oversight duties. The Staff observed that the NRSRO's records do not capture any recommendations made by the board to management. The Staff also learned that the board was briefed on the Staff's 2011 examination findings, but was not given a copy of the exam letter until March 2012, in response to the Staff's inquiry. Further, the Staff is concerned that the board may not have actively participated in the NRSRO management's response to, and implementation of, the Staff's 2011 examination findings and recommendations. The Staff recommended that the NRSRO ensure that its board members are actively exercising their Section 15E(t)(3) duties and that sufficient records of board activity are maintained.

At one of the smaller NRSROs, the NRSRO board did not appear to be adequately informed about its oversight duties and the Staff did not receive any documentation from the NRSRO establishing its board or demonstrating that the directors performed the Section 15E(t)(3) oversight duties. The Staff recommended that the NRSRO inform its board of the statutory duties and maintain adequate documentation in connection with the performance of such duties.

2. Certain of the policies and procedures, including the codes of conduct, of several NRSROs do not apply to all members of the boards of directors or governing committees.

Certain policies and procedures or codes of conduct of two of the larger NRSROs and three of the smaller NRSROs do not apply to board or governing committee members who are not NRSRO employees. The Staff recommended that all five of the NRSROs make such policies and procedures, and codes of conduct, applicable to all members of the boards of directors and governing committees.

3. Oversight committee members of one of the smaller NRSROs serve dual roles.

An NRSRO's board of directors or governing committee is required to oversee, among other things, the establishment, maintenance and enforcement of policies and procedures for determining credit ratings as required under Section 15E(t)(3)(A). The Staff found that certain members of the oversight committee of a smaller NRSRO also served as members of the rating committee and voted to take particular rating actions. The Staff is concerned that such dual roles may result in the members of the oversight committee reviewing actions they took as rating committee members, and may limit the objectivity and overall effectiveness of the oversight function for determining credit ratings. The Staff recommended that this smaller NRSRO consider the effect of having the oversight committee members serve in such dual roles.

4. The boards of two of the smaller NRSROs did not meet certain regulatory requirements of Section 15E(t).

The board of one of the smaller NRSROs did not meet Section 15E(t) requirements. The board did not have the number of independent directors required by the statute during the Review Period. Additionally, independent director compensation appears insufficient to compensate the directors for their time and attention to board activities. The Staff recommended that the NRSRO address these issues to ensure that its board is in compliance with requirements of Section 15E(t).

Section 15E(t)(2)(C) requires independent directors to have a pre-agreed fixed term not exceeding 5 years, which cannot be renewable. Two of the smaller NRSROs have not established a pre-agreed fixed term for independent directors. The Staff recommended that such term be established.

F. Review Area: DCO Activities

Section 15E(j) requires each NRSRO to designate an individual responsible for administering the policies and procedures established to prevent the misuse of material non-public information and manage conflicts of interest and for ensuring compliance with the securities laws. In addition, the DCO is prohibited from engaging in certain activities, including performing credit ratings or participating in the development of ratings methodologies or models. The DCO is responsible for establishing procedures for the receipt, retention, and treatment of complaints. The DCO must be compensated in a manner not linked to financial performance of the NRSRO and that ensures the DCO's independence. Further, the DCO 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 and the NRSRO must file the report with the Commission.

The Staff considers the DCO role to be a critical element in 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 regarding the DCOs are as follows:

1. At one of the larger NRSROs and one of the smaller NRSROs, the DCOs' roles and responsibilities did not fully conform to the statutory requirements.

The Staff found that the DCO at one of the larger NRSROs appeared to have only a supporting role in carrying out the statutory duties enumerated in Section 15E(j). These statutory duties include administering the policies and procedures for the prevention of misuse of non-public information, the management of conflicts of interest, and for ensuring compliance with securities laws. They also include establishing procedures for the receipt, retention, and treatment of complaints. The Staff noted that some of these responsibilities fall under a Deputy Chief Compliance Officer who does not report to the NRSRO's DCO, but instead reports to the Chief Compliance Officer of the parent company who is not bound by provisions of the statute.

In addition, the Staff observed that the former DCO of one of the smaller NRSROs did not adequately perform the duties required by Section 15E(j). The former DCO did not appear to have the necessary skills, autonomy, resources, or understanding of the statutory responsibilities. The Staff observed an overall lack of implementation of policies, procedures, and internal controls as well as a lack of oversight of compliance issues and training. In addition, the Staff is concerned that, given the organizational structure of the NRSRO, the DCO position may not have adequate independence and authority to fulfill the DCO responsibilities.

The Staff made recommendations to these NRSROs regarding improvements to their DCOs' roles and responsibilities.

2. At one larger NRSRO and one smaller NRSRO, the DCOs' annual reports need improvement.

The Staff is concerned that the DCO's annual report to one of the larger NRSROs does not provide sufficient insight regarding the state of the NRSRO's compliance with the securities laws and the NRSRO's policies and procedures, such as compliance risks, known violations, potential compliance issues, and challenges faced by the NRSRO's compliance department and appears to be limited to identifying only "material weaknesses," as defined by the NRSRO.

One of the smaller NRSROs was one year late in filing its 2010 annual compliance report with the Commission. The Staff is concerned that the content of this NRSRO's 2010 and 2011 annual reports does not meet the statutory requirements and that its 2011 annual report did not contain the required DCO certification. The Staff made various recommendations to these two NRSROs regarding implementing improvements to their DCOs' annual reports.

3. The DCO compensation policies at two of the smaller NRSROs could be improved.

One of the smaller NRSROs does not have a policy regarding the compensation of its DCO. The DCO compensation policy of one of the other smaller NRSROs does not state how the goal of ensuring the independence of the DCO's judgment will be accomplished or how the variable component of the DCO's compensation is determined.

The Staff made various recommendations to these two smaller NRSROs regarding implementing improvements to their DCO compensation policies.

4. The Staff identified some other concerns about the DCO's activities at some of the NRSROs.

In addition to the issues otherwise specifically discussed in this Report, the Staff generally noted some other concerns about the DCO's activities at other NRSROs. The Staff made recommendations to these NRSROs regarding improvements for the DCO's access to the board and for the DCO to have documented plans for compliance reviews and staff training.

G. Review Area: Complaints

Section 15E(j)(3) 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 developed under Section 15E; 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. Rule 17g-2(c) requires that such communications be retained for a period of three years. Rule 17g-2(d) dictates the manner of retention and Rule 17g-2(e) governs the use of third party custodians for retention. The Staff reviewed each NRSRO's policies and procedures for complaints and tested the policies and procedures.

The Staff found that all the NRSROs have written policies and procedures generally to address these requirements, but some specific requirements were not covered. The Staff made recommendations to the NRSROs regarding the identified weaknesses.

The Staff's essential findings regarding complaints are as follows:

1. The complaints policies and procedures at one of the larger NRSROs and four of the smaller NRSROs do not fully address the requirements of Section 15E(j)(3) and the rules thereunder.

Section 15E(j)(3)(A) requires the establishment of procedures for the receipt, retention, and treatment of complaints regarding credit ratings, models, methodologies, and compliance with the securities laws and the NRSRO's policies and procedures developed under Section 15E.

Three of the smaller NRSROs' policies did not fully address the handling of the required types of complaints. One of the larger NRSROs and one of the smaller NRSROs did not address the handling of complaints regarding the NRSRO's policies and procedures developed under Section 15E and the rules thereunder in their written policies and procedures.

Section 15E(j)(3)(B) requires the establishment of procedures for the receipt, retention and treatment of confidential, anonymous complaints by employees or users of credit ratings. Two of the smaller NRSROs had not established procedures for the submission of confidential, anonymous complaints. One of the larger NRSROs did not mention the methods by which employees may submit complaints anonymously in its written policies and procedures. Two other smaller NRSROs did not provide sufficient or easily accessible information regarding how users of credit ratings may submit anonymous complaints.

The Staff noted that the NRSROs have varying levels of specificity in their policies and procedures for the treatment of complaints. However, the Staff found that the policies of one of the smaller NRSROs simply state that complaints will be forwarded to the compliance department, with no further procedural guidance. Similarly, at another of the smaller NRSROs, there were also no written procedures after forwarding complaints to the compliance department and the forwarding requirement covered written complaints only, not verbal complaints which must also be addressed.

The Staff recommended that the respective NRSROs revise their policies and procedures addressing complaints and related procedures as required by Section 15E(j)(3).

2. Two of the larger NRSROs and one of the smaller NRSROs failed to follow their complaints policies and procedures in some instances. One smaller NRSRO reported not having received any complaints but it appears at least one complaint was received.

The Staff reviewed a sample of complaint files at each of the NRSROs, with the exception of four of the smaller NRSROs that asserted they did not receive any complaints during the Review Period. The Staff found that there were compliance issues with internal complaints policies and procedures at two of the larger NRSROs and one of the smaller NRSROs. The Staff recommended that one larger NRSRO provide more training for its employees on complaints policies and procedures. For the other larger NRSRO, the Staff recommended that it ensure that the process outlined in its complaint policies and procedures is consistently followed. For the smaller NRSRO, the Staff recommended that it provide procedures for the confidential submission of complaints. One other smaller NRSRO stated it did not receive any complaints during the Review Period, and the Staff was concerned that it in fact did receive at least one complaint that was not properly identified as a complaint. The Staff recommended that this smaller NRSRO establish procedures for the treatment of complaints that satisfy the requirements of the statute and rules.

3. The Staff identified other areas where the NRSROs' complaints 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 complaints policies and procedures. The Staff made various recommendations to the NRSROs regarding improvements.

H. Review Area: Post-Employment

Section 15E(h)(4)(A) 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 tested those procedures.

The Staff found that all of the NRSROs had established written policies and procedures to address the look-back requirement. Below are the Staff's essential findings regarding NRSRO look-back policies and procedures:

1. The Staff found weaknesses in one larger NRSRO's and two smaller NRSROs' implementation of look-back policies and procedures and related recordkeeping.

At one of the larger NRSROs, many look-back reviews were not completed within the timeframe required by the NRSRO's policies, and several look-back reviews conducted during the Review Period were incorrectly dated. Additionally, two smaller NRSROs made very limited efforts to identify the new employers of former employees.

2. The Staff found one smaller NRSRO's look-back policies and procedures have not been implemented.

One smaller NRSRO has policies and procedures that remain in draft form and have not been implemented.

The Staff made recommendations to the NRSROs regarding the identified weaknesses.

VI. CONCLUSION

The Staff conducted the second of its annual Section 15E examinations of each of the 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.