

SECURITIES AND EXCHANGE COMMISSION
Release No. 34-71219

December 31, 2013

Order Granting Temporary Exemption of Morningstar Credit Ratings, LLC from the Conflict of Interest Prohibition in Rule 17g-5(c)(1) of the Securities Exchange Act of 1934

I. Introduction

Rule 17g-5(c)(1) of the Securities Exchange Act of 1934 (“Exchange Act”) prohibits a nationally recognized statistical rating organization (“NRSRO”) from issuing or maintaining a credit rating solicited by a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue equaling or exceeding 10% of the total net revenue of the NRSRO for the fiscal year. In adopting this rule, the Commission stated that such a person would be in a position to exercise substantial influence on the NRSRO, which in turn would make it difficult for the NRSRO to remain impartial.¹

II. Application and Exemption Request of Morningstar Credit Ratings, LLC

Morningstar Credit Ratings, LLC (“Morningstar”), formerly known as Realpoint, LLC (“Realpoint”), is a credit rating agency registered with the Commission as an NRSRO under Section 15E of the Exchange Act for the class of asset-backed securities ratings, described in clause (iv) of Section 3(a)(62)(A) of the Exchange Act. On June 23, 2008, the Commission granted Realpoint a temporary exemption from Rule 17g-5(c)(1) in connection with its initial registration as an NRSRO (“Realpoint Exemptive Order”). Morningstar has traditionally operated mainly under the “subscriber-paid” business model, in which the NRSRO derives its revenue from restricting access to its ratings to paid subscribers. After Morningstar acquired Realpoint in the spring of 2010, Morningstar began to expand the scope of its business and initiated an issuer-paid ratings service for initial ratings on commercial mortgage-backed

¹ Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33598 (June 18, 2007).

securities (“CMBS”). In connection with this expansion, the Commission granted Morningstar an exemption from Rule 17g-5(c)(1) on March 5, 2012,² (“Morningstar Exemptive Order” and, together with the Realpoint Exemptive Order, the “Previous Exemptive Orders”) which covered the 2011 and 2012 fiscal years, and was effective until January 1, 2013.

Morningstar states that the exemption will enable it to continue to diversify its revenue into other markets and products. Morningstar further states that a high concentration of issuers/arrangers in the CMBS market coupled with the comparatively higher fees paid for an initial rating than those of a single subscriber increases the chances that when a smaller NRSRO, such as Morningstar, enters into the initial ratings business it will potentially violate Rule 17g-5(c)(1). Accordingly, Morningstar has requested that the Commission grant it an extension of the temporary exemption from Rule 17g-5(c)(1) until January 1, 2015.

III. Discussion

The Commission, when adopting Rule 17g-5(c)(1), 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.³ The Commission noted in the Previous Exemptive Orders that an exemption would further the primary purpose of the Credit Rating Agency Reform Act of 2006 (“Rating Agency Act”) to “improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating industry.”⁴ The Commission cited these same factors in granting exemptions to LACE Financial Corp⁵ and Kroll Bond Rating Agency, Inc.⁶

² Release No. 34-66514 (March 5, 2012), 77 FR 14580-14581 (March 12, 2012).

³ Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33598 (June 18, 2007).

⁴ See Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006).

⁵ Securities Exchange Act Release No. 34-57301 (Feb. 11, 2008), 73 FR 8720 (Feb. 14, 2008).

⁶ Securities Exchange Act Release No. 65339 (Sep. 14, 2011), 76 FR 58319 (Sep. 20, 2011).

Morningstar has informed Commission staff that in the current fiscal year, Morningstar may receive more than 10% of its total net revenue from one or more clients that paid it to rate asset-backed securities. In the request that is subject to this order, Morningstar stated that it expects to have more diverse revenue sources over time and that a temporary exemption from Rule 17g-5(c)(1) would enable it to grow its NRSRO business further so that eventually it will not need an exemption.

The Commission believes that a temporary, limited, and conditional exemption allowing Morningstar to continue to diversify its business beyond CMBS ratings is consistent with the Commission's goal, as established by the Rating Agency Act, of improving ratings quality by fostering accountability, transparency, and competition in the credit rating industry, and is necessary and appropriate in the public interest and consistent with the protection of investors. In order to maintain this exemption, Morningstar will be required to comply with the following conditions: (1) Morningstar shall review, update, maintain, and comply with policies, procedures, and internal controls specifically designed to address the conflict of interest created by exceeding the 10% threshold, including that Morningstar's Designated Compliance Officer ("DCO") shall review a sample of rating files from fiscal years 2013, 2014 and 2015 for ratings solicited by the applicable client or clients that provided Morningstar with 10% or more of its total net revenue, shall take other steps acceptable to the examination staff to verify that ratings of any such clients were not influenced by commercial concerns and that Morningstar adhered to its policies, procedures, and internal controls concerning the conflict created by exceeding the 10% threshold, and shall report quarterly about these efforts to Morningstar's President and Nominating and Corporate Governance Committee; (2) Morningstar's President shall file with the Commission, on a quarterly basis, a certification that ratings on deals for any client or clients

that provided Morningstar with 10% or more of its total net revenue sufficiently adhered to policies, procedures, and internal controls to address the conflict of interest created by exceeding the 10% threshold and that the DCO took appropriate efforts to confirm this adherence; (3) Morningstar shall appropriately address, as applicable, the Commission staff's 2013 and 2014 annual Section 15E(p) examination findings and recommendations; (4) net revenue from a single client may not exceed 20% of Morningstar's total net revenue for either the fiscal year ending December 31, 2013 or the fiscal year ending December 31, 2014; and (5) Morningstar shall publicly disclose in Exhibit 6 to Form NRSRO, as applicable, that the firm received 10% or more of its total net revenue in fiscal year 2013 or 2014 from a client or clients.

Section 15E(p) of the Exchange Act, as added by Section 932(a)(8) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires Commission staff to conduct an examination of each NRSRO at least annually. As an integrated part of the applicable annual examinations, OCR staff will examine Morningstar's satisfaction of the conditions to this order set forth in Section IV below. If the conditions are not being fulfilled to the staff's satisfaction, the staff will consider whether to recommend that the Commission take additional action, administrative or otherwise.

The Commission therefore finds that a temporary, limited, and conditional exemption allowing Morningstar to continue to diversify its business beyond CMBS ratings is consistent with the Commission's goal, as established by the Rating Agency Act, of improving ratings quality by fostering accountability, transparency, and competition in the credit rating industry and is necessary and appropriate in the public interest and consistent with the protection of investors, subject to Morningstar's satisfaction of the conditions set forth below.

IV. Conclusion

Accordingly, pursuant to Section 36 of the Exchange Act,

IT IS HEREBY ORDERED that Morningstar Credit Ratings, LLC, formerly known as Realpoint, LLC, is exempt from the conflict of interest prohibition in Exchange Act Rule 17g-5(c)(1) until January 1, 2015, with respect to any revenue derived from issuer-paid ratings, provided that: (1) Morningstar shall review, update, maintain, and comply with policies, procedures, and internal controls specifically designed to address the conflict of interest created by exceeding the 10% threshold, including that Morningstar's Designated Compliance Officer shall review a sample of rating files from fiscal years 2013, 2014 and 2015 for ratings solicited by the applicable client or clients that provided Morningstar with 10% or more of its total net revenue, shall take other steps acceptable to the examination staff to verify that ratings of any such clients were not influenced by commercial concerns and that Morningstar adhered to its policies, procedures, and internal controls concerning the conflict created by exceeding the 10% threshold, and shall report quarterly about these efforts to Morningstar's President and Nominating and Corporate Governance Committee; (2) Morningstar's President shall file with the Commission, on a quarterly basis, a certification that ratings on deals for any client or clients that provided Morningstar with 10% or more of its total net revenue sufficiently adhered to policies, procedures, and internal controls to address the conflict created by exceeding the 10% threshold and that the Designated Compliance Officer took appropriate efforts to confirm this adherence; (3) Morningstar shall appropriately address, as applicable, the Commission staff's 2013 and 2014 annual Section 15E(p) examination findings and recommendations; (4) net revenue from a single client shall not exceed 20% of Morningstar's total net revenue for either the fiscal year ending December 31, 2013 or the fiscal year ending December 31, 2014; and (5)

Morningstar shall publicly disclose in Exhibit 6 to Form NRSRO, if applicable, that it received 10% or more of its total net revenue in fiscal year 2013 or 2014 from one or more issuers/arrangers.

By the Commission.

Elizabeth M. Murphy
Secretary