

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 74103 / January 21, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16347

In the Matter of

STANDARD & POOR'S
RATINGS SERVICES,

Respondent.

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

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15E(d) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Standard & Poor's Ratings Services ("S&P" or "Respondent").

II.

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

III.

On the basis of this Order and S&P's Offer, the Commission finds¹ that:

SUMMARY

1. These proceedings involve S&P's failure to maintain and enforce internal controls regarding changes made to an assumption used in surveilling certain Residential Mortgage Backed Securities ("RMBS") supported primarily by seasoned (*i.e.*, pre-2005) collateral with amortization periods of less than 30 years (*i.e.*, short-amortizing collateral or loans).

2. In August 2012, S&P published updated criteria for surveillance of ratings of RMBS backed by pre-2009 originations (the "Criteria"). The Criteria sets forth S&P's established methodology for determining the appropriate loss severity ("LS") assumptions to be used in surveilling these ratings. S&P's LS assumptions represent the estimated losses that would be incurred if a mortgage defaults and are a significant part of S&P's ratings analyses.

3. However, from approximately October 2012 through January 2014, S&P did not apply the LS assumptions set forth in the Criteria to its surveillance reviews in connection with bonds supported by seasoned, short-amortizing loans with low loan-to-value ("LTV") ratios. Instead, S&P conducted surveillance reviews of approximately 150 transactions containing short-amortizing loans using LS assumptions that were lower than those set forth in the Criteria.

4. When changing its LS assumptions for this type of loan pool, S&P did not follow its internal control policies and procedures for making changes to criteria. Throughout the relevant time period, the group that performed RMBS surveillance (the "RMBS Group") communicated with various persons within S&P's internal control structure about the proper approach to surveilling ratings of bonds backed by these pools and possible changes to the Criteria, but none of these persons assured that S&P timely updated the Criteria or disclosed and documented the LS assumptions actually used in its surveillance reviews.

5. While S&P did disclose the use of lower LS assumptions in a few press releases, S&P did not fully explain its methodology to determine the specific LS assumptions used to surveil ratings of bonds supported by pools with seasoned, short-amortizing loans until September 2014, when it published notices about its different methodology. Throughout the relevant period, S&P produced inconsistent and incomplete external disclosures and internal records concerning the LS assumptions it used in its surveillance of bonds supported by seasoned, short-amortizing collateral. S&P's internal controls failed to timely detect and prevent these documentation errors.

6. S&P self-reported this issue to the Commission and took voluntarily steps to remediate and address the issues that are described herein, including clarifying its approach to the surveillance of transactions supported by short-amortizing collateral in a published Criteria

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

FAQ entitled “Criteria FAQ: Loss Severity Assumptions For Securitizations Backed By Highly Seasoned Prime Jumbo And Larger-Balance Alt-A Loans” which explained S&P’s past and future use of LS assumptions. S&P has also voluntarily undertaken significant remedial measures and, in response to the Commission’s investigation in this matter, has provided substantial cooperation to Commission staff.

RESPONDENT

7. S&P is a Nationally Recognized Statistical Rating Organization (“NRSRO”) headquartered in New York City, New York. Standard & Poor’s Ratings Services is comprised of a separately identifiable business unit within Standard & Poor’s Financial Services LLC, a Delaware limited liability company wholly-owned by McGraw Hill Financial, Inc. (“MHFI”), and the credit ratings business housed within certain other wholly-owned subsidiaries of, or businesses continuing to operate as divisions of, MHFI.

FACTS

The Criteria and Pools with Short-Amortizing Loans

8. On August 9, 2012, S&P published the Criteria in an update called “Methodology And Assumptions: U.S. RMBS Surveillance Credit And Cash Flow Analysis For Pre-2009 Originations[.]” Among other things, the Criteria described the methodology that S&P would follow to determine the LS assumptions to be used to conduct surveillance on ratings of RMBS bonds containing pre-2009 collateral. First, the Criteria provides that if sufficient data were available S&P would calculate the LS assumptions based on the actual performance of the pool, or of closely related pools, over a finite time period. Second, if the data were not sufficient for such a calculation, S&P would assume LS based on the loan type and the year that the RMBS pool was created. Loan types were designated as prime, Alt-A, negative amortization, or subprime. The assumptions were published in the Criteria in a matrix called Table 3. For example, pursuant to Table 3, the LS assumption for prime pools formed before 2005 would be 40%, while the LS for Alt-A pools formed before 2005 would be 50%. Finally, Paragraph 14 of the Criteria stated as follows:

We have derived the credit and cash flow assumptions in these criteria at the loan, pool, or cohort level and will apply them to all in-scope transactions. We may apply additional quantitative and/or or [sic] qualitative analysis in certain limited circumstances. We expect to conduct additional analysis for less than 10% of the cases. For instance, in situations where we apply cohortwide rating assumptions to a specific transaction whose performance or portfolio characteristics vary significantly from other transactions within its cohort, we may consider the specific differentiating factors when determining the appropriate assumptions to apply.

9. Once the applicable LS assumptions were determined, S&P would then multiply the LS percentage by the anticipated frequency of loan defaults to estimate total potential losses for the loan pool. Based on these calculations, which included assumptions designed to estimate how

the loans would perform in stressed economic conditions, S&P would determine whether to take a rating action (*i.e.*, upgrade, downgrade or affirm) on its ratings of the bonds.

10. While S&P was considering publication of the Criteria, persons within the RMBS Group raised the concern that the LS assumptions in Table 3 might be too high for pools with seasoned, short-amortizing loans. It is generally expected that LS for seasoned, short-amortizing loans could be lower than for 30-year loans. The final Criteria, however, made no distinction between pools with short-amortizing loans and pools containing loans with 30-year amortization schedules.

11. Throughout the relevant period, S&P had a specific methodology for changing criteria, called the Criteria Process Guidelines. These Guidelines set forth procedures for researching and approving proposed criteria changes and publishing those changes when made. Before September 2014, S&P did not publish any Criteria article specifying different LS assumptions used to surveil RMBS pools with short-amortizing loans.

Application of Lower LS Assumptions to Pools of Loans With Less than 30-Year Amortization Schedules

12. Following publication of the Criteria in August 2012, S&P policy required that the firm review all outstanding ratings within the scope of the Criteria within six months. This meant that the RMBS Group needed to review ratings for approximately 5,000 RMBS transactions. Because RMBS transactions typically include many different bonds, each of which carries its own rating, this required review of approximately 60,000 ratings within a six-month period. This represented a large volume of surveillance reviews for S&P's RMBS Group to conduct within this time period.

13. Shortly after beginning its surveillance, the RMBS Group concluded that the Table 3 LS assumptions were not appropriate for pools with predominately seasoned, short-amortizing loans. However, rather than proposing a revision to the Criteria, the RMBS Group determined that it could apply lower LS assumptions under Paragraph 14 of the Criteria and developed an approach to consistently apply lower LS assumptions in surveillance reviews of such pools.

14. The RMBS Group discussed the application of lower LS assumptions with certain persons from two separate groups within S&P's internal control structure: the Quality Group and the Criteria Group.²

15. In an October 15, 2012 email, the RMBS Criteria Officer told the RMBS Group that she agreed with the use of a 20% LS assumption, rather than the 40% provided for by Table 3, for the surveillance of ratings on pools with prime jumbo collateral, originated prior to 2005, with at least 85% of the pool composed of 15-year fixed rate loans. Neither the Quality Group nor the

² The Quality Group was responsible for reviewing ratings to determine whether the ratings procedure was appropriately documented and complied with published criteria. The Criteria Group was responsible for providing guidance to the analytical group on application of criteria and for enforcing the internal procedures for changes to criteria.

Criteria Group required that the change in LS assumptions for these short-amortizing loans follow the process outlined in S&P's Criteria Process Guidelines because they believed the use of a lower LS assumption for this limited subset of collateral was permissible under Paragraph 14 of the Criteria.

16. In October and December 2012, the RMBS Group submitted two instructions to the production staff, which maintained the model that S&P used for RMBS surveillance, to override the default 40% LS assumption and to apply a lower LS assumption for a number of RMBS structures with short-amortizing collateral. These modifications to the LS assumptions resulted in material differences in the output of S&P's surveillance model.

17. From October 2012 through January 2014, S&P published rating actions in connection with its surveillance of multiple batches of RMBS, which included approximately 150 transactions that S&P surveilled using LS assumptions (usually 20%) that were lower than the values in Table 3 of the Criteria. The RMBS Group believed these lower assumptions were analytically appropriate.

18. For each bulk surveillance review conducted, S&P prepared an internal document called a Rating Analysis and Methodology Profile ("RAMP"). RAMPs are a critical part of S&P's internal control procedures. According to S&P's RAMP Guidelines, "The RAMP's objective is to explain the rating recommendation to voting committee members [who approved the proposed rating] through application of criteria. The RAMP captures the key drivers of the issue being rated, the relevant facets of analysis, the pertinent information being considered, and the underlying criteria and applicable assumptions" Each of the RAMPs included a copy of the Criteria Table 3, along with adjacent text that indicated that the LS assumptions in Table 3 were used to surveil at least some of the bonds in the batch. However, none of the RAMPs included any discussions about deviations from Table 3 for pools with short-amortizing loans as part of the text adjacent to Table 3, although some of the RAMPs did include some information about the use of different LS assumptions for pools with short-amortizing loans elsewhere in the RAMP document.

19. In addition, in connection with each bulk surveillance review conducted, S&P published a press release describing its ratings actions and its methodology for such actions. Only three of the press releases contained meaningful discussions of the deviations from Table 3.

20. The RMBS Group recognized the importance of internal and external disclosure and record-keeping whenever they departed from the Table 3 LS assumptions. In an email dated December 14, 2012, the Lead Analytical Manager of the RMBS Group asked for the following when analysts used the different LS assumptions:

1. Consistent ramp disclosure – consider press release disclosure also
2. Maintaining a database of deals where this is applied
3. Documentation of process – how often will these be updated
4. External article in Jan or Feb (when all deals have been resolved) about this type of collateral (less than 30 mainly 15 year).

21. Still, the RMBS group did not consistently include information about S&P's different approach to pools with seasoned, short-amortizing loans in the RAMPs and press releases. The omission of information from the RAMPs and press releases about the actual LS assumptions used for the relevant pools rendered these documents incomplete for their intended purposes. The Quality Group, which was responsible for assuring adequate documentation of S&P's ratings, knew about the RMBS Group's different approach to these pools but did not identify or correct this omission.

First Proposal to Amend Criteria for Short-Amortizing Loans

22. In December 2012 and January 2013, members of the RMBS Group developed, but then later withdrew, a written proposal to change the Criteria's LS assumptions for pools with short-amortizing loans, including proposed modifications to Table 3. The proposal did not disclose that the RMBS Group had already changed its approach to pools with seasoned, short-amortizing loans, and it went beyond the changes the Criteria Officer previously considered in October 2012. The Criteria Officer concluded that the new proposal constituted a criteria change, rather than an interpretation.

23. After the RMBS Group withdrew the proposal, senior personnel in the Criteria Group stated in emails to certain members of the RMBS Group that the application of Paragraph 14 of the Criteria should be limited to unique situations, and not applied on a systematic basis. Despite these statements, the RMBS Group continued to believe that the Table 3 assumptions were not analytically appropriate for seasoned, short-amortizing loans. The RMBS Group continued to apply lower LS assumptions in surveilling pools with seasoned, short-amortizing loans and thereby did not surveil ratings in compliance with the Criteria.

Compliance Review of LS Assumptions as Part of a Broad Inquiry into Employee Complaint

24. In February 2013, an employee in the RMBS Group brought numerous concerns to the attention of S&P's Compliance Department. The Compliance Department was responsible for conducting an internal investigation of the concerns raised to evaluate whether there was evidence of possible violations of internal S&P policies and procedures and to recommend appropriate action.

25. One of the concerns raised by the RMBS employee was that the Table 3 assumptions in the Criteria were too high for pools with short-amortizing loans. The Compliance Department conducted an inquiry and found that the employee's analytical disagreement with the Table 3 assumptions was not a policy violation.

26. The Compliance Department inquiry regarding the employee's complaints ended May 1, 2013. Later in May, the Compliance Department learned that the RMBS Group was not consistently applying the Table 3 assumptions to pools with short-amortizing loans, but had conducted surveillance reviews of over 100 ratings using LS assumptions that were lower than the values provided for in Table 3. The Compliance Department opened a second inquiry into whether the use of the lower LS assumptions was consistent with the Criteria.

Second Proposal to Amend Criteria and Continuing Uncertainty Concerning Methodology

27. At various points in the spring and summer of 2013, members of the Criteria and Quality Groups learned that the RMBS Group was conducting surveillance reviews of RMBS using non-Table 3 LS assumptions. In July 2013 the RMBS Group approached the Structured Finance Criteria Committee (“SFCC”) with a written proposal to amend the Criteria to clarify the LS assumptions that were being applied during the surveillance process for short-amortizing collateral.

28. The SFCC considered the proposal at a meeting on July 24, 2013, and requested additional research into the impact of the change. S&P then formed a “working group” to continue to research and develop the criteria proposal about LS assumptions for short-amortizing loans. Although there was widespread agreement within S&P that the application of lower LS assumptions for short-amortizing collateral was analytically appropriate and should be formally incorporated into the Criteria, S&P did not reach a consensus on specific changes until more than a year later.

29. Both in the written proposal and at the SFCC meeting, the RMBS Group clearly informed the SFCC that the purpose of the proposal was to ratify the existing practice of the RMBS Group, rather than to propose new action for the future. However, no one associated with the SFCC deliberations took any steps to ensure that the Criteria was updated before the RMBS Group continued to apply the lower LS assumptions to seasoned, short-amortizing loans. They also did not confirm whether the RMBS Group was adequately documenting and disclosing the LS assumptions being used for short-amortizing collateral.

30. As noted above, in August 2013, the Compliance Department opened a second inquiry to consider the RMBS Group’s use of non-Table 3 LS assumptions. During the Compliance Department’s review, it became apparent that there was a lack of clarity among relevant S&P personnel as to the specific LS assumptions that were being used and should be used. There were also inconsistent views as to whether the use of lower LS assumptions was permissible under Paragraph 14 of the Criteria or was a change to the Criteria. The Compliance Officer who conducted the inquiry determined in a preliminary draft report that non-Table 3 LS assumptions should not have been applied without additional levels of review and approval within S&P.

31. In January 2014, the RMBS Group decided to stop using non-Table 3 LS assumptions for the surveillance of ratings of bonds supported by pools with short-amortizing loans, pending the resolution of the pending criteria proposal. This decision was made with the expectation that the SFCC would soon consider and approve LS assumptions for pools with short-amortizing loans. However, the SFCC continued to consider different methodologies for several months.

32. S&P still used non-Table 3 LS assumptions to surveil a small number of bonds supported by pools with seasoned, short-amortizing loans in 2014, but surveillance reviews on other bonds supported by such pools were delayed pending the resolution of the criteria proposal. As a result of the delay in amending the Criteria, the RMBS Group experienced a backlog of

delayed surveillance. These delays conflicted with S&P policies and procedures that required timely surveillance of ratings.

S&P's Notices to the Public

33. In addition to the press releases referenced above, on May 3, 2013, the RMBS Group published an article entitled “Examining The Components Of Loan-Level Loss Severity in U.S. RMBS.” The article stated, *inter alia*, that “[t]he 15-year fixed-rate structure is an example of when we might adjust our loss-severity assumption based on differentiating factors such as product type and group-level HPI-adjusted LTV.”

34. On August 28, 2014, S&P’s highest criteria board, the Analytics Policy Board (“APB”), reviewed the LS assumptions for seasoned, short-amortizing collateral and concluded that, in the vast majority of instances, the application of lower LS assumptions was analytically appropriate and that the Criteria should be updated. Nevertheless, S&P determined that it needed to review LS assumptions for short-amortizing loans originated between 2005 and 2008, and on September 9, 2014, S&P published an Advance Notice of Criteria Change reflecting that decision.

35. Also on September 9, 2014, S&P published an article entitled “Criteria FAQ: Loss Severity Assumptions For Securitizations Backed By Highly Seasoned Prime Jumbo And Larger-Balance Alt-A Loans” that clarified the LS assumptions S&P had used and intends to use to surveil securitization backed by seasoned, short-amortizing loans consistent with the APB’s conclusion. S&P resolved the backlog of its surveillance reviews in connection with bonds supported by short-amortizing collateral. S&P also disclosed error corrections in connection with certain prior rating actions for which a surveillance review had been conducted using a lower LS assumption in circumstances that did not fall within the September 9, 2014 Criteria FAQ.

VIOLATIONS

36. As a result of the conduct described above, S&P violated Section 15E(c)(3)(A) of the Exchange Act, which requires NRSROs to establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings.

37. As a result of the conduct described above, S&P willfully violated Rules 17g-2(a)(2)(iii) and 17g-2(a)(6) under the Exchange Act, which require NRSROs to make and retain complete and current records of the rationale for any material difference between the credit rating implied by a model and the final credit rating issued for asset-backed or mortgage-backed securities transactions and of the established procedures and methodologies used by the NRSRO to determine credit ratings.³

³ A willful violation of the securities laws means merely “that the person charged with the duty knows what he is doing.” *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor “also be aware that he is violating one of the Rules or Acts.” *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

COOPERATION AND REMEDIATION

38. In determining to accept the Offer, the Commission considered S&P's self-reporting of this issue to the Commission staff, the remedial acts promptly undertaken by S&P and the substantial cooperation S&P afforded the Commission staff in this matter.

UNDERTAKINGS

S&P has undertaken the following:

S&P will determine the analytically appropriate LS assumptions for pools with short-amortizing loans and will publish, within thirty (30) days of the date of this Order, updated criteria disclosing these LS assumptions.

S&P, within ninety (90) days of the date of this Order, will develop measures to enhance its written policies and procedures and internal control structure relating to the process for changes to and approval of criteria which will be implemented on a timeframe set in consultation with the Office of Credit Ratings.

S&P, within sixty (60) days of the date of this Order, will address any future deviations from criteria in two ways: (1) development of standard and conspicuous language to be used at the start of press releases and presales where ratings resulted from deviations from published criteria; and (2) tracking of all deviations from published criteria, including records of the corresponding approval for such deviations, with the appointment of an overseer for purposes of collection and on-going review of such data.

S&P shall certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to, Thomas Butler, Director, Office of Credit Ratings, Securities and Exchange Commission New York Regional Office, 3 World Financial Center, Suite 400, New York, NY 10281-1022, and Michael J. Osnato, Jr., Chief, Complex Financial Instruments Unit, Securities and Exchange Commission, 3 World Financial Center, Suite 400, New York, NY 10281-1022, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in S&P's Offer.

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

A. S&P cease and desist from committing or causing any violations and any future violations of Section 15E(c)(3)(a) of the Exchange Act and Exchange Act Rules 17g-2(a)(2)(iii) and 17g-2(a)(6).

B. S&P is censured.

C. S&P shall, within thirty (30) days of the entry of this Order, pay a civil money penalty of \$1 million to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways:

- (1) S&P may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) S&P may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) S&P may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

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

Payments by check or money order must be accompanied by a cover letter identifying S&P as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Michael J. Osnato, Division of Enforcement, Securities and Exchange Commission, 200 Vesey Street, Suite 4000, New York, New York 10281.

By the Commission.

Brent J. Fields
Secretary