

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

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 90036 / September 29, 2020**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-20096**

**In the Matter of**

**KROLL BOND RATING AGENCY,  
LLC**

**Respondent.**

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

**I.**

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

**II.**

In anticipation of the institution of these proceedings, KBRA 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, KBRA 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 KBRA’s Offer, the Commission finds that:

**Summary**

1. KBRA’s internal controls relating to its rating of conduit/fusion commercial mortgage backed-securities (“CMBS”) had deficiencies that resulted in material weaknesses in its internal control structure. Section 15E(c)(3)(A) of the Exchange Act requires that “[e]ach nationally

recognized statistical rating organization shall 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, taking into consideration such factors as the Commission may prescribe, by rule.”

2. Under Rule 17g-3, an NRSRO’s internal control structure is not “effective” if there were one or more material weaknesses in the internal control structure. A material weakness exists if a deficiency, or a combination of deficiencies, in the design and operation of the internal control structure creates a reasonable possibility that an NRSRO’s management or employees, in the normal course of performing their assigned functions, will fail to prevent or detect on a timely basis a material failure by the NRSRO to: (a) implement a policy, procedure, or methodology for determining credit ratings in accordance with the policies and procedures of the NRSRO; or (b) adhere to an implemented policy, procedure, or methodology for determining credit ratings. *See* Rule 17g-3(a)(7)(ii)-(iv), 17 C.F.R. § 240.17g-3(a)(7).

3. In determining credit ratings for conduit/fusion CMBS, analysts took into account projected decline in revenue from properties that are in default, which it labelled internally as the Revenue Decline After Default (“RDAD”). KBRA’s established procedures and methodologies for determining credit ratings for conduit/fusion CMBS permitted analysts to use their professional judgment to make an adjustment for an RDAD but omitted any analytical method for determining the applicability of, magnitude of, or recording the rationale for, the RDAD adjustment. KBRA’s internal controls failed to prevent or detect that omission.

4. Additionally, KBRA’s written procedures suggested that RDAD adjustments are made on a property-specific basis; however, between 2012 and 2017, KBRA principally made RDAD adjustments on a portfolio-level basis. KBRA’s internal controls failed to prevent or detect that ambiguity in the record of KBRA’s methodology for determining conduit/fusion CMBS ratings.

### **Respondent**

5. KBRA is a Delaware limited liability company, headquartered in New York, NY, and KBRA or its predecessor in interest has been registered as a Nationally Recognized Statistical Rating Organization (“NRSRO”) since 2008.

### **Background**

#### **A. Overview of the CMBS Rating Process**

6. In conduit/fusion CMBS transactions, an issuer acquires a pool of commercial mortgage loans and sells notes that will be repaid based on the cash flow from those loans.

7. Broadly speaking, KBRA follows a two-step process for rating conduit/fusion CMBS transactions, described in its published CMBS ratings methodology. First, KBRA assesses the cash flow and value of the loans in the collateral pool. Second, KBRA conducts scenario-based deterministic credit modeling of the transaction to generate individual lifetime expected losses for the loans in the collateral pool, which is a key determinant in the rating.

8. The first step involves evaluating a majority (by principal balance) of properties in the collateral pool as unique pieces of real estate and determining each property's likely cash flow. More specifically, KBRA analysts assess the properties' ability to generate revenue as well as the expenses they incur in generating that revenue. One of the outputs of this process – property-specific net cash flows – is a key input in the second step in which the agency performs its credit modeling.

9. In the second step, KBRA uses a scenario-based deterministic credit model (which was created to give effect to the CMBS methodology) to generate the individual lifetime expected losses for the loans, the aggregation of which is a key determinant for the ratings. The individual lifetime expected losses are used, along with other factors, to assign transaction ratings.

10. The model's output is the deal's expected losses at each stress assumption expressed as percentages. Those percentages are the subordination levels for the various rating categories. For example, if the model returns a 20% expected loss figure under the stresses that KBRA's methodology applies to AAA-rated bonds; then, in such a circumstance, to get a AAA rating, a bond would have to have 20% subordination.

11. The model is intended to apply the quantitative elements of KBRA's established procedure and methodology in a manner that adheres to that established procedure and methodology.

12. The deal arrangers – often large investment banks – solicit preliminary ratings from NRSROs and then hire one or more NRSROs to rate the bonds. These preliminary subordination levels are a key factor used by CMBS arrangers to determine which NRSRO(s) to hire to rate the transaction. All else equal, the NRSROs retained were those with the lowest credible subordination levels. This is so because, generally speaking, investors were satisfied with receiving lower interest rates for notes with a higher rating, and lower interest rates made the transaction more profitable for arrangers.

#### **B. KBRA's Documentation Of Its Established CMBS Procedures and Methodology Failed to Completely Describe a Material Step**

13. The methodology that KBRA used during the relevant period contained a number of different analytical steps. For example, the methodology involved projecting cash flows under certain assumed stress conditions, such as particular loans defaulting. The model assumed that, if a loan defaulted, the property that secured that loan would experience a decline in revenue. The methodology thus contained an analytical step called "Revenue Decline After Default." Briefly stated, RDAD adjusts the projected decline in revenue from properties that are in default. The rationale for the projected decline is that buildings securing loans in default suffer reputational and other harms that could result in, *inter alia*, existing tenants not renewing leases and potential new tenants declining to enter into leases, and therefore the building securing the defaulted loan will suffer a decline in revenue post-default.

14. KBRA's methodology since February 2012 had stated that:

The first adjustment is a reduction in revenue to account for property specific post default dynamics. We assume that such reduction could occur for a variety of reasons, which may include property mismanagement as well as the failure of some tenants to pay rent due to co-tenancy clauses. Properties encumbered by defaulted loans may also have a stigma attached to them that prompts tenants with near term lease expirations to not renew their leases. In other scenarios, tenants with near term lease expirations may try to leverage the situation to negotiate lower rents.

15. From 2012 through January 2017, the RDAD adjustment principally was made on a portfolio-wide basis; that is to say that one RDAD rate was input into the model, which then applied it to all, or nearly all, loans in the pool.

16. In January 2017, KBRA changed the model to calculate a separate RDAD for each property, instead of simply applying one RDAD to the entire portfolio.

**C. KBRA's Internal Control Structure Failed to Permit KBRA Employees to Prevent or Detect KBRA's Failure to Implement and Adhere to Procedures for Applying an RDAD Adjustment**

17. KBRA's internal control structure had material weaknesses resulting from two deficiencies.

18. First, as noted above, KBRA's written procedures for determining conduit/fusion CMBS ratings omitted any analytical method for determining the applicability of, magnitude of, or recording the rationale for, the RDAD adjustment. KBRA's internal controls failed to prevent or detect that omission because there was no control, such as a review comparing the written procedures for determining the RDAD to the actual analytical practices being used. Such a control would have determined that the record documenting the procedures was incomplete, and that the actual as-applied analyses documented in the ratings files were inadequate to determine whether the RDAD adjustment referred to in the methodology had been complied with.

19. Second, also as noted above, between 2012 and 2017, KBRA's record of its methodology for determining conduit/fusion CMBS ratings suggested that RDAD adjustments are made on a property-specific basis; however, during that time period, KBRA permitted its analysts to make RDAD adjustments on a portfolio-level basis. KBRA's internal controls failed to prevent or detect the ambiguity in KBRA's record of its methodology for determining ratings for conduit/fusion CMBS because there was no control, such as a review comparing the record of KBRA's methodology to the record of the analysis used to determine credit ratings for specific conduit/fusion CMBS transactions. Such a control would have detected that analysts were actually making the RDAD adjustment principally on a portfolio-wide basis rather than a property-specific basis, and caused KBRA to clarify the ambiguity in the record of its methodology.

**Violation**

20. As a result of the conduct described above, KBRA willfully<sup>1</sup> violated Exchange Act Section 15E(c)(3)(A) by failing to establish, maintain and enforce effective internal controls governing the implementation and adherence to its policies, procedures, and methodologies for determining conduit/fusion CMBS ratings.

#### IV.

#### **Undertakings**

KBRA has undertaken to do the following within 180 days of the entry of this Order:

A. **Training.** KBRA will conduct a live training program addressing the requirements of Section 15E(c)(3)(A). This training program shall educate attendees regarding the Section 15E(c)(3)(A) requirement that KBRA 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. This training program shall also educate attendees about their role in complying with Section 15E(c)(3)(A). KBRA will train: (1) personnel responsible for establishing, maintaining, enforcing and documenting an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings; (2) personnel who are required to comply with that internal control structure, and (3) personnel responsible for creating, implementing, and adhering to policies, procedures, and methodologies for determining credit ratings. This training shall also explain how employees can raise concerns and the avenues for doing so, including internally and directly with the Commission through the Whistleblower Program.

B. **Review and Correction of Documentation and Internal Controls, Policies, and Procedures.** KBRA will, within 180 days of the entry of this Order, review the application of its internal processes, policies and procedures regarding the implementation of and adherence to procedures and methodologies for determining credit ratings and take the necessary actions to ensure that they accurately reflect the strictures of Section 15E(c)(3)(A), including establishing, maintaining, enforcing, and documenting policies and procedures requiring:

- (1) the review of the written records of each of its established procedures and methodologies for determining credit ratings to ensure that those records:
  - (a) accurately reflect (i) all analytical steps that are actually taken in determining credit ratings, and (ii) the analytical methodology applied in each such step, including, where applicable, the analytical methodology used to determine the applicability of that step and the values used or applied in that step; and

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<sup>1</sup> “Willfully,” for purposes of imposing relief under Section 15E(d) of the Exchange Act, “means no more than that the person charged with the duty knows what he is doing.” *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor “also be aware that he is violating one of the Rules or Acts.” *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). The decision in *The Robare Group, Ltd. v. SEC*, which construed the term “willfully” for purposes of a differently structured statutory provision, does not alter that standard. 922 F.3d 468, 478-79 (D.C. Cir. 2019) (setting forth the showing required to establish that a person has “willfully omit[ted]” material information from a required disclosure in violation of Section 207 of the Advisers Act).

- (b) require that analysts document the steps taken in determining a credit rating with sufficient detail to permit an after-the-fact review or internal audit of the rating file to determine whether the analysts adhered to the established procedures and methodologies for determining credit ratings; and
- (2) the periodic review of a reasonable sample of rating files to determine whether the relevant established procedures and methodologies for determining credit ratings were adhered to in determining those ratings.

C. **Certificate of Compliance.** A duly authorized officer of KBRA shall certify in writing, under penalty of perjury, compliance with each of the above undertakings. The certification shall identify each of the above undertakings with which KBRA believes it has complied and shall provide written evidence of compliance in the form of a narrative which is supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and KBRA agrees to provide such evidence. The certification and supporting material shall be submitted to Reid A. Muoio, Deputy Chief, Complex Financial Instruments Unit, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Mail Stop 6013 SP1, Washington, DC 20549 with a copy to the Office of Chief Counsel of the Enforcement Division. This certification shall be submitted no later than six months from the date of this order. Respondent agrees that if the Division of Enforcement believes that Respondent has not satisfied these undertakings, it may petition the Commission to reopen the matter to determine whether additional sanctions are appropriate.

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

## V.

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

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

A. KBRA cease and desist from committing or causing any violations and any future violations of Exchange Act Section 15E(c)(3)(A);

B. KBRA is hereby censured; and

C. KBRA shall pay a civil money penalty in the amount of \$1,250,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). Payment shall be made in the following installments: KBRA shall pay \$312,500 of this amount within thirty (30) days of the entry of this Order. KBRA shall pay the remaining \$937,500 of this amount within three hundred and sixty-four (364) days of the entry of this Order. Payments shall be applied first to post-order interest, which accrues pursuant to 31 U.S.C. § 3717. Prior to making the final payment set forth herein, Respondent shall contact the staff of the

Commission for the amount due. If Respondent fails to make any payment by the date agreed and/or in the amount agreed according to the schedule set forth above, all outstanding payments under this Order, including post-order interest, minus any payments made, shall become due and payable immediately at the discretion of the staff of the Commission without further application to the Commission.

Payment must be made in one of the following ways:

- (1) KBRA may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) KBRA 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) KBRA 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 KBRA 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 Reid A. Muoio, Deputy Chief, Complex Financial Instruments Unit, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Mail Stop 6013 SP1, Washington, DC 20549.

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

of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

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

By the Commission.

Vanessa A. Countryman  
Secretary