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For more information, contact:

Alec Koch
+1 202 626 8982
akoch@kslaw.com

Carmen Lawrence
+1 212 556 2193
clawrence@kslaw.com

Yelena Kotlarsky
+1 212 556 2207
ykotlarsky@kslaw.com

King & Spalding

New York
1185 Avenue of the Americas
New York, New York 10036-4003
Tel: +1 212 556 2100

Washington, D.C.
1700 Pennsylvania Avenue, NW
Washington, D.C. 20006-4707
Tel: +1 202 737 0500

Morningstar's SEC Settlement Underscores Importance of Avoiding Conflicts of Interest

On May 15, 2020, Morningstar Credit Ratings LLC, agreed, without admitting or denying the SEC's findings, to resolve an SEC proceeding finding violations of a conflict of interest rule aimed at credit rating agencies and to pay a $3.5 million fine.[1] The SEC's Order found that Morningstar failed to separate its credit ratings and analysis operations from its sales and marketing efforts in violation of the rule, which is intended to remove undue influence from the credit rating process. The SEC's action against Morningstar represents the first time that the SEC has charged a Nationally Recognized Statistical Rating Organization ("NRSRO") under this regulation, which was promulgated in 2014.

The regulation, Exchange Act Rule 17g-5(c)(8)(i), is aimed at preventing those employees who determine credit ratings from feeling pressured to issue higher ratings to favor an existing or prospective client. As a consequence, the rule prevents these employees from having any role in sales and marketing activities.

According to the SEC's Order, Morningstar's head of business development for asset-backed securities instructed rating analysts to arrange marketing calls and meetings with potential clients, repeatedly follow up with those clients, and offer them indicative ratings. In one instance, the business development head could not attend an event at a potential client's office and sent an analyst in his place. The analyst subsequently followed up with an email pursuing a meeting with the company to pitch Morningstar's products and services. In another instance, an analyst made multiple efforts to reach out to a potential client, including offering to provide an indicative rating on a security issued by the potential client and publishing a commentary on the credit strength of certain notes in the potential client's deals. That company eventually became a Morningstar client. Managers received regular reports about analysts' client recruitment efforts and analysts emphasized those efforts during self-evaluations.

The SEC's order found that these actions violated Rule 17g-5(c)(8)(i), as well as Section 15E(h)(1) of the Exchange Act, which required the Commission to promulgate rules designed to insulate sales and marketing considerations from influencing an NRSRO's ratings. In addition to the monetary penalty, Morningstar agreed to enhance its policies, procedures and internal controls, as well as improve its compliance training.

The SEC has long expressed the importance of avoiding conflicts of interest, with a special emphasis on the issues arising from the "issuer pays" model employed by most NRSROs. In the adopting release for Exchange Act Rule 17g-5(c)(8), the SEC noted the role of credit rating agencies as critical "gatekeepers" for the primary benefit of the users of credit ratings and emphasized that they face conflicts of interest that need to be "carefully monitored."[2] Therefore, the restriction against mixing sales and marketing activities with rating analysis is an "absolute prohibition" designed "to insulate individuals within the NRSRO responsible for the analytic function from sales and marketing concerns and pressures."[3]

In both its public statements and during annual exam reports, the SEC's Office of Credit Ratings (OCR) has repeatedly highlighted the management of conflicts of interest as a key focus area. In an address given earlier this year, Jessica Kane (head of OCR) indicated that conflict of interest management, along with internal supervisory controls and adherence to policies and procedures, represent nearly 75% of all annual exam findings.[4] OCR's 2019 annual report summarizing its examinations of ratings agencies highlighted several examples in which rating agencies' analytical personnel participated in sales and marketing efforts.[5] In one example involving a larger rating agency, a senior commercial employee communicated with members of the analytical team just prior to the start of the rating committee regarding the client's timing needs and the sensitivity of the transaction. The same person also contacted an employee involved with determining rating criteria to advise on the use of analytical judgement in the rating. In another example, the SEC found that a large rating agency asked analytical employees to contact potential clients to discuss a new product offered by the firm. It also asked analysts to develop lists of key influencers in their respective sectors, many of whom were issuers, and provided a script to analysts instructing them to initiate conversations with issuers regarding the new product.

Although OCR has often emphasized the importance of conflict of interest management, this is the SEC's first enforcement action against a rating agency for violations of Exchange Act Rule 17g-5(c)(8)(i) since it was promulgated in 2014. Rating agency actions against NRSROs have generally focused on conduct such as failure to adhere to the credit rating agency's published criteria and methodologies, as well as failure to properly disclose certain aspects of, or deviations from, their rating models.[6]

Because the SEC's oversight of NRSROs is relatively new and there have been few enforcement actions, rating agencies should pay close attention to SEC staff speeches and other statements, as well as the findings that OCR publishes in its annual exam reports. NRSROs also can look for guidance to other areas where the SEC has actively regulated potential conflicts of interest, such as the oversight of equity research analysts, and consider implementing the following practices:

- Clearly delineate separate reporting lines for analytical personnel and sales and marketing personnel.
- Ensure that analytical personnel are not compensated or evaluated based on business development initiatives.
- Restrict access to files such that sales and marketing and analytical personnel can only access documents belonging to their respective groups.
- Consider physically separating sales and marketing and analytical personnel.
- Hold separate meetings with a current or prospective client to discuss analytical matters or fees. If one meeting is held to discuss both topics, arrange the logistics so that analytical personnel are not present for the fee discussion.

- Establish a risk management function to periodically evaluate and monitor risks such as conflicts of interest.
- Provide an avenue for employees to report concerns.
- Remediate any findings of improper conduct quickly.

Rating agencies would be well advised to implement these steps and demonstrate that they are taking conflict of interest issues seriously. As the SEC's public statements, exam findings, and most recent enforcement action have demonstrated, the SEC views management of conflicts as a priority and will take enforcement action against rating agencies that fail to appropriately manage this issue.

[1] *In the Matter of Morningstar Credit Ratings, LLC*, Release No. 88880 (May 15, 2020), ***available at*** https://www.sec.gov/litigation/admin/2020/34-88880.pdf

[2] SEC, 'Nationally Recognized Statistical Rating Organizations', Release No 34-72936 (August 27, 2014), ***available at*** https://www.sec.gov/rules/final/2014/34-72936.pdf

[3] *Id.* at 100.

[4] Jessica Kane, Director, Office of Credit Ratings, The SEC's Office of Credit Ratings and NRSRO Regulation: Past, Present, and Future (Feb. 24, 2020), ***available at*** https://www.sec.gov/news/speech/speech-jessica-kane-2020-02-24#_ednref19

[5] SEC, 2019 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization, ***available at*** https://www.sec.gov/files/nrsro-summary-report-2019.pdf

[6] ***See, e.g.***, In the Matter of Moody's Investors Services, Inc., Release No. 34-83965 (Aug. 28, 2018), ***available at*** https://www.sec.gov/litigation/admin/2018/34-83965.pdf; *In the Matter of DBRS, Inc.*, Release No. 34-76261 (October 26, 2015), ***available at*** https://www.sec.gov/litigation/admin/2015/34-76261.pdf; *In the Matter of Standard & Poor's Ratings Services*, Release No. 33-9705 (Jan. 21, 2015), ***available at*** https://www.sec.gov/litigation/admin/2015/33-9705.pdf; *In the Matter of Standard & Poor's Ratings Services*, Release No. 34-74103 (Jan. 21, 2015), ***available at*** https://www.sec.gov/litigation/admin/2015/34-74103.pdf.