

SECURITIES AND EXCHANGE COMMISSION
Release No. 34-71220

December 31, 2013

Order Granting Temporary Exemption of Kroll Bond Rating Agency, Inc. 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 Kroll Bond Rating Agency, Inc.

Kroll Bond Rating Agency, Inc. (“Kroll”), formerly known as LACE Financial Corp. (“LACE”), is a credit rating agency registered with the Commission as an NRSRO under Section 15E of the Exchange Act for the classes of credit ratings described in clauses (i) through (v) of Section 3(a)(62)(A) of the Exchange Act. The Commission has previously granted Kroll a temporary exemption from Rule 17g-5(c)(1), until January 1, 2013, in connection with its entering the market for rating structured finance products (“Kroll Order”).² The Commission had also previously granted a temporary exemption from Rule 17g-5(c)(1) to LACE in

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

² Exchange Act Release No. 34-65339 (Sept. 14, 2011), 76 FR 58319, 58321 (Sept. 20, 2011).

connection with its initial registration as an NRSRO³ (“LACE Order,” and collectively with the Kroll Order, “Previous Exemptive Orders”).

Kroll has informed the Commission that it intends to further expand its existing NRSRO business into other sectors of the capital markets. In connection with this planned expansion, Kroll has requested an extension of its temporary and limited exemption from Rule 17g-5(c)(1) on the grounds that the restrictions imposed by Rule 17g-5(c)(1) would pose a substantial constraint on the firm’s ability to grow its business further and thereby foster competition in the credit rating industry. Specifically, Kroll states that the number of commercial mortgage-backed securities (“CMBS”) issuers in the market is limited, and that business development in other areas has been affected by market conditions and barriers to entry. Accordingly, Kroll has requested that the Commission grant it an extension of its 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.⁴ The Commission noted several factors in granting the Previous Exemptive Orders, including that the exemptions 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.”⁵ Citing the same factors, the Commission has issued similar orders granting temporary exemptions from the requirements of

³ Exchange Act Release No. 34-57301 (Feb. 11, 2008), 73 FR 8720 (Feb. 14, 2008).

⁴ Exchange Act Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33598 (June 18, 2007).

⁵ 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).

Rule 17g-5(c)(1) to Realpoint LLC, in connection with its registration as an NRSRO,⁶ and to Morningstar Credit Ratings, LLC, the successor to Realpoint LLC.⁷

Kroll has informed Commission staff that in the current fiscal year, Kroll 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, Kroll states 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 further grow its NRSRO business so that eventually it will not need an exemption.

The Commission believes that a temporary, limited, and conditional exemption allowing Kroll 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 is consistent with the protection of investors. In order to maintain this exemption, Kroll will be required to comply with the following conditions: (1) Kroll 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 Kroll'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 Kroll 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 Kroll 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 Kroll's CEO and board of directors; (2) Kroll's CEO shall file

⁶ Exchange Act Release No. 34-58001 (June 23, 2008), 73 FR 36362 (June 26, 2008).

⁷ Exchange Act Release No. 34-66514 (March 5, 2012), 77 FR 14580 (Mar. 12, 2012).

with the Commission, on a quarterly basis, a certification that ratings on deals for any client or clients that provided Kroll 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) Kroll 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 25% of Kroll's total net revenue for either the fiscal year ending December 31, 2013 or the fiscal year ending December 31, 2014; and (5) Kroll 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, Commission staff will examine Kroll'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 Kroll 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, subject to the conditions set forth below, and is necessary and appropriate in the public interest and is consistent with the protection of investors.

IV. Conclusion

Accordingly, pursuant to Section 36 of the Exchange Act,

IT IS HEREBY ORDERED that Kroll Bond Rating Agency, Inc., formerly known as LACE Financial Corp., 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) Kroll 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 Kroll'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 Kroll 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 Kroll 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 Kroll's CEO and board of directors; (2) Kroll's CEO shall file with the Commission, on a quarterly basis, a certification that ratings on deals for any client or clients that provided Kroll 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 Designated Compliance Officer took appropriate efforts to confirm this adherence; (3) Kroll 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 25% of Kroll's total net revenue for either the fiscal year ending December 31, 2013 or the fiscal year ending December 31, 2014; and (5) Kroll 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.

By the Commission.

Elizabeth M. Murphy
Secretary