

SECURITIES AND EXCHANGE COMMISSION
Release No. 34-76766

December 24, 2015

Order Granting Temporary, Limited, and Conditional 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 Securities and Exchange Commission (“Commission”) stated that a person soliciting a credit rating who was the source of 10% or more of the total net revenue of the NRSRO 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 given the impact on the NRSRO’s income if the person withdrew its business.¹ Section 36 of the Exchange Act authorizes the Commission to exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of the Exchange Act or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

II. 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 credit ratings described in clause (iv) of section

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

3(a)(62)(A) of the Exchange Act. The Commission has previously granted Morningstar two temporary exemptions from Rule 17g-5(c)(1): (1) until January 1, 2013, allowing Morningstar to expand in the market for rating structured finance products on an issuer-paid basis (“First Morningstar Order”);² and (2) until January 1, 2015, to allow Morningstar to continue to diversify its business beyond commercial mortgage-backed securities (“CMBS”) ratings (“Second Morningstar Order”).³ The Commission also previously granted a temporary exemption from Rule 17g-5(c)(1) to Realpoint in connection with its initial registration as an NRSRO (“Realpoint Order” and, collectively with the First Morningstar Order and Second Morningstar Order, “Previous Exemptive Orders”).⁴

Morningstar has informed the Commission that while it has expanded its credit ratings activity to new asset classes in addition to CMBS, it needs more time to further diversify its business and accomplish its goal to lower its revenue concentration below the 10% threshold. Accordingly, Morningstar has requested a two-year extension of its exemption from Rule 17g-5(c)(1) to enable the continued growth of its business and, thereby, foster competition in the credit rating industry.

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.⁵ The Commission noted several factors in granting the Previous Exemptive Orders, including that the exemptions would further the primary purpose of

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

³ Release No. 34-71219 (Dec. 31, 2013).

⁴ Release No. 34-58001 (June 23, 2008), 73 FR 36362 (June 26, 2008).

⁵ Release No. 34-55857, 72 FR 33598.

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 agency industry.”⁶ Citing the same factors, the Commission has issued similar orders granting temporary exemptions from the requirements of Rule 17g-5(c)(1) to LACE Financial Corp. (“LACE”), in connection with its registration as an NRSRO,⁷ and to Kroll Bond Rating Agency, Inc., the successor to LACE.⁸

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 states that it seeks to further diversify its credit ratings business and that a temporary extension of the exemption from Rule 17g-5(c)(1) would provide it the time needed to sufficiently lower its revenue concentration.

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 agency industry and is necessary or 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, comply with, and document policies, procedures, and internal controls specifically designed to address the conflict of interest created

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

⁷ Release No. 34-57301 (Feb. 11, 2008), 73 FR 8720 (Feb. 14, 2008).

⁸ Release No. 34-65339 (Sept. 14, 2011), 76 FR 58319 (Sept. 20, 2011); Release No. 34-71220 (Dec. 31, 2013); Release No. 34-76129 (Oct. 13, 2015).

by exceeding the 10% threshold, including that Morningstar's Designated Compliance Officer ("DCO") shall: (a) conduct and document, on at least a quarterly basis, a review of a sample of rating files from its 2015, 2016, and 2017 fiscal years for credit ratings solicited by the applicable client or clients that provided Morningstar with 10% or more of its total net revenue, and take other steps acceptable to the Commission's examination staff, to verify that ratings of any such clients were not influenced by commercial concerns and that Morningstar adhered to such policies, procedures, and internal controls; and (b) deliver quarterly written reports about these efforts to Morningstar's President and Nominating and Corporate Governance Committee;

(2) within 5 business days after the end of each quarter beginning with the last quarter of its 2015 fiscal year and through the end of its 2017 fiscal year, Morningstar's President shall file with the Commission a certification that all credit ratings issued through the end of each such quarter on deals for any client or clients that provided Morningstar with 10% or more of its total net revenue sufficiently adhered to its policies, procedures, and internal controls to address the conflict of interest created by exceeding the 10% threshold, that the DCO took appropriate measures, including rating file reviews, to confirm this adherence, and that identifies the credit ratings issued for any such clients during such quarter; (3) Morningstar shall appropriately address the Commission staff's findings and recommendations in the 2015 annual section 15E(p)(3) examination and any other examinations conducted by Commission staff during 2015, 2016, or 2017; (4) net revenue received by Morningstar from a single client may not exceed 13% of Morningstar's total net revenue for the fiscal year ending December 31, 2015, and net revenue received by Morningstar from a single client may not exceed 12% of Morningstar's total net revenue for the fiscal year ending December 31, 2016; (5) Morningstar shall publicly disclose, as applicable, in Exhibit 6 to Form NRSRO that it received 10% or more of its total net revenue in

fiscal years 2015 and 2016 from a client or clients; and (6) Morningstar shall retain documentation demonstrating compliance with the conditions of the exemption.

Section 15E(p)(3) of the Exchange Act, as added by section 932(a)(8) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires the Commission's Office of Credit Ratings ("OCR") 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.

IV. Conclusion

Accordingly, pursuant to section 36 of the Exchange Act,

IT IS HEREBY ORDERED that Morningstar is exempt from the conflict of interest prohibition in Exchange Act Rule 17g-5(c)(1) until January 1, 2017 with respect to any revenue derived from issuer-paid credit ratings, provided that: (1) Morningstar shall review, update, maintain, comply with, and document policies, procedures, and internal controls specifically designed to address the conflict of interest created by exceeding the 10% threshold, including that Morningstar's DCO shall: (a) conduct and document, on at least a quarterly basis, a review of a sample of rating files from its 2015, 2016, and 2017 fiscal years for credit ratings solicited by the applicable client or clients that provided Morningstar with 10% or more of its total net revenue, and take other steps acceptable to the Commission's examination staff, to verify that ratings of any such clients were not influenced by commercial concerns and that Morningstar adhered to such policies, procedures, and internal controls; and (b) deliver quarterly written reports about these efforts to Morningstar's President and Nominating and Corporate

Governance Committee; (2) within 5 business days after the end of each quarter beginning with the last quarter of its 2015 fiscal year and through the end of its 2017 fiscal year, Morningstar's President shall file with the Commission a certification that all credit ratings issued through the end of each such quarter on deals for any client or clients that provided Morningstar with 10% or more of its total net revenue sufficiently adhered to its policies, procedures, and internal controls to address the conflict of interest created by exceeding the 10% threshold, that the DCO took appropriate measures, including rating file reviews, to confirm this adherence, and that identifies the credit ratings issued for any such clients during such quarter; (3) Morningstar shall appropriately address the Commission staff's findings and recommendations in the 2015 annual section 15E(p)(3) examination and any other examinations conducted by Commission staff during 2015, 2016, or 2017; (4) net revenue received by Morningstar from a single client shall not exceed 13% of Morningstar's total net revenue for the fiscal year ending December 31, 2015, and net revenue received by Morningstar from a single client shall not exceed 12% of Morningstar's total net revenue for the fiscal year ending December 31, 2016; (5) Morningstar shall publicly disclose, as applicable, in Exhibit 6 to Form NRSRO that it received 10% or more of its total net revenue in fiscal years 2015 and 2016 from a client or clients; and (6) Morningstar shall retain documentation demonstrating compliance with the conditions of the exemption.

By the Commission.

Brent Fields
Secretary