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# **Annual Report on Nationally Recognized Statistical Rating Organizations**

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**As Required by Section 6 of the  
Credit Rating Agency Reform  
Act of 2006**



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**December 2012**

**This is a report of the staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained in this report.**

# ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

## As Required by Section 6 of the Credit Rating Agency Reform Act of 2006

### I. INTRODUCTION

The U.S. Securities and Exchange Commission (“Commission”) is providing this report under Section 6 of the Credit Rating Agency Reform Act of 2006 (“Rating Agency Act”).<sup>1</sup> Section 6 of the Rating Agency Act requires the Commission to submit an annual report to the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate and the Committee on Financial Services of the U.S. House of Representatives that, with respect to the year to which the report relates:

- Identifies applicants for registration as nationally recognized statistical rating organizations (“NRSROs”) under Section 15E of the Securities Exchange Act of 1934 (“Exchange Act”);
- Specifies the number of and actions taken on such applications; and
- Specifies the views of the Commission on the state of competition, transparency, and conflicts of interest among NRSROs.

This report relates to the period from June 26, 2011 to June 25, 2012 (the “reporting period”).<sup>2</sup> The report provides an overview of Commission rulemaking and other actions

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<sup>1</sup> Pub. L. 109-291, 120 Stat. 1327, S. 3850 (Sept. 29, 2006). The Rating Agency Act, among other things, added Section 15E to the Exchange Act (15 U.S.C. 78o-7) to establish self-executing requirements on NRSROs and provide the Commission with the authority to implement a registration and oversight program for NRSROs. On June 5, 2007, the Commission approved rules implementing such a program. See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55857, 72 FR 33564 (Jun. 18, 2007) (“June 2007 Adopting Release”). The implementing rules were Form NRSRO (17 CFR 249b.300) and Rules 17g-1 through 17g-6 (17 CFR 240.17g-1 through 17g-6). The Commission has twice adopted amendments to some of these rules. See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 59342 (Feb. 2, 2009), 74 FR 6456 (Feb. 9, 2009) (“February 2009 Adopting Release”) and Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 61050 (Nov. 23, 2009), 74 FR 63832 (Dec. 4, 2009) (“November 2009 Adopting Release”). The Commission has also adopted new Rule 17g-7 (17 CFR 240.17g-7). See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Securities Act of 1933 Release No. 9175; Exchange Act Release No. 63741 (Jan. 20, 2011), 76 FR 4515 (Jan. 26, 2011).

<sup>2</sup> The first annual report, which was published in June 2008, related to the period from June 26, 2007, the effective date of the Rating Agency Act, to June 25, 2008. The first annual report and subsequent annual reports are on the Office of Credit Ratings page of the Commission’s website at: <http://www.sec.gov/about/offices/ocr.shtml>.

relating to NRSROs and addresses the items specified in Section 6 of the Rating Agency Act for the reporting period.

## II. COMMISSION RULEMAKING AND OTHER ACTIONS RELATING TO NRSROs

The Office of Credit Ratings (“OCR”) was established in June 2012 with the appointment of Director Thomas Butler. The Office was created by the Dodd–Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) and is responsible for the oversight of credit rating agencies registered with the Commission as NRSROs. OCR’s staff consists of approximately 25 lawyers, accountants, and examiners responsible for examining and monitoring the NRSROs.<sup>3</sup>

During the reporting period, the Commission issued the following releases and staff reports relating to NRSROs or credit ratings in general:

- 2011 Summary Report of Commission Staff’s Examinations of Each Nationally Recognized Statistical Rating Organization, as required under Section 15E(p)(3)(C) of the Exchange Act.<sup>4</sup>
- Treatment of Asset-Backed Issuers under the Investment Company Act, Investment Company Act Release No. 29779 (Aug. 31, 2011), 76 FR 55308 (Sept. 7, 2011).<sup>5</sup>
- Security Ratings, Securities Act Release No. 9245 (July 27, 2011), 76 FR 46603 (Aug. 3, 2011).<sup>6</sup>
- Report on Review of Reliance on Credit Ratings (July 2011), as required by Section 939A(c) of the Dodd-Frank Act.

Final action has not been taken on the following releases reported in last year’s annual report:

- Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 64514 (May 18, 2011), 76 FR 33420 (Jun. 8, 2011) (“May 2011 Proposing Release”).<sup>7</sup>

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<sup>3</sup> <http://www.sec.gov/news/press/2012/2012-113.htm>.

<sup>4</sup> The 2012 Summary Report of Commission Staff’s Examinations of Each Nationally Recognized Statistical Rating Organization, as required under Section 15E(p)(3)(C) of the Exchange Act, was issued on November 15, 2012.

<sup>5</sup> The Commission issued an advance notice of proposed rulemaking that requested public comment on possible amendments to Rule 3a-7 under the Investment Company Act including, among other things, the role, if any, that credit ratings should continue to play in that rule. The Commission also withdrew its proposal to remove credit ratings from Rule 3a-7 that was issued on July 1, 2008.

<sup>6</sup> The Commission adopted amendments to rules and forms under the Securities Act of 1933 and the Exchange Act to remove references to credit ratings.

- Solicitation of Comment to Assist in Study on Assigned Credit Ratings, Exchange Act Release No. 64456 (May 10, 2011), 76 FR 28265 (May 16, 2011).<sup>8</sup>
- Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, Exchange Act Release No. 64352 (Apr. 27, 2011), 76 FR 26550 (May 6, 2011).<sup>9</sup>

The Commission continues to assess the efficacy of the rules and regulations and will continue to suggest legislative and rule changes to enhance the Commission’s NRSRO oversight, as deemed necessary.

Additionally, the Commission staff chairs IOSCO’s<sup>10</sup> Committee 6 on credit rating agencies. The responsibility of Committee 6 is to: (1) discuss, evaluate and consider regulatory and policy initiatives vis-à-vis credit rating agency activities and oversight, in an effort to seek cross-border regulatory consensus through such means as the IOSCO credit rating agency code; and (2) facilitate regular dialogue between securities regulators and the credit rating industry.

### III. STATUS OF REGISTRANTS AND APPLICANTS

Section 3(a)(62) of the Exchange Act defines a “nationally recognized statistical rating organization” as a credit rating agency that issues credit ratings certified by qualified institutional buyers, in accordance with Section 15E(a)(1)(B)(ix) of the Exchange Act, with respect to: (i) financial institutions, brokers, or dealers; (ii) insurance companies; (iii) corporate issuers; (iv) issuers of asset-backed securities (as that term is defined in 17 CFR 229.1101(c)); (v) issuers of government securities, municipal securities, or securities issued by a foreign government; or (vi) a combination of one or more categories of obligors described in any of clauses (i) through (v); and that is registered under Exchange Act Section 15E.

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<sup>7</sup> The Commission proposed for comment rule amendments and new rules in accordance with the Dodd-Frank Act and to enhance oversight that would require NRSROs to, among other things: report on internal controls; protect against conflicts of interest; establish professional standards for credit analysts; publicly provide—along with the publication of a credit rating—disclosure about the credit rating and the methodology used to determine it; enhance their public disclosures about the performance of their credit ratings; and make certain submissions to the Commission electronically. The proposal also would require issuers and underwriters of asset-backed securities, as well as NRSROs, to make disclosures concerning third-party due diligence reports.

<sup>8</sup> The Commission requested comment to assist it in carrying out a study on, among other matters, the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine credit ratings for structured finance products. The study, as well as a resulting report to Congress, is required by Section 939F of the Dodd-Frank Act.

<sup>9</sup> The Commission proposed for comment amendments to Exchange Act Rules 15c3-1, 15c3-3, 17a-4, 101 and 102 of Regulation M, and 10b-10, and one Exchange Act form (Form X-17A-5, Part IIB) to remove references to credit ratings and, in certain cases, substitute alternative standards of creditworthiness as required by Section 939A of the Dodd-Frank Act. The Commission also requested public comment on potential standards of creditworthiness for purposes of Exchange Act Sections 3(a)(41) and 3(a)(53), which define the terms “mortgage related security” and “small business related security,” respectively.

<sup>10</sup> The International Organization of Securities Commissions (“IOSCO”) is a multilateral organization of securities regulators in which the Commission actively participates.

Through the end of the reporting period, the Commission had granted registration as an NRSRO under Section 15E to ten credit rating agencies.<sup>11</sup> During the reporting period, one of these credit rating agencies withdrew its registration as an NRSRO.<sup>12</sup> The registered credit rating agencies, dates of initial registration, categories of credit ratings described in clauses (i) through (v) of Exchange Act Section 3(a)(62)(A) in which they are registered, and locations of their principal offices are, as of the end of the reporting period:<sup>13</sup>

<b>NRSRO / Categories of Credit Ratings</b>	<b>Registration Date</b>	<b>Principal Office</b>
A.M. Best Company, Inc. (“A.M. Best”) Categories (ii), (iii), and (iv)	September 24, 2007	U.S.
DBRS, Inc. (“DBRS”) Categories (i) through (v)	September 24, 2007	U.S.
Egan-Jones Ratings Co. (“EJR”) Categories (i) through (v)	December 21, 2007	U.S.
Fitch, Inc. (“Fitch”) Categories (i) through (v)	September 24, 2007	U.S.
Japan Credit Rating Agency, Ltd. (“JCR”) Categories (i), (ii), (iii), and (v)	September 24, 2007	Japan
Kroll Bond Rating Agency, Inc. (“KBRA”) <sup>14</sup> Categories (i) through (v)	February 11, 2008	U.S.
Moody’s Investors Service, Inc. (“Moody’s”) Categories (i) through (v)	September 24, 2007	U.S.
Morningstar Credit Ratings, LLC (“Morningstar”) <sup>15</sup> Category (iv)	June 23, 2008	U.S.
Standard & Poor’s Ratings Services (“S&P”) Categories (i) through (v)	September 24, 2007	U.S.

<sup>11</sup> After the reporting period, the Commission granted registration as an NRSRO to HR Ratings de México, S.A. de C.V., for the class of credit ratings described in clause (v) of Section 3(a)(62)(A) of the Exchange Act. See Exchange Act Release No. 34-68160 (Nov. 5, 2012).

<sup>12</sup> On October 13, 2011, Rating and Investment Information, Inc., which had been registered with the Commission as an NRSRO since September 24, 2007, furnished the Commission with a notice of withdrawal from registration as an NRSRO. The withdrawal became effective on November 27, 2011. See <http://www.sec.gov/news/digest/2011/dig112811.htm>.

<sup>13</sup> See the current Form NRSRO for each firm for any updates of this information.

<sup>14</sup> Formerly known as LACE Financial Corp.

<sup>15</sup> Formerly known as Realpoint LLC.

In April 2012, the Commission's Division of Enforcement instituted administrative proceedings against EJR and Sean Egan, EJR's founder, President, owner, and primary analyst.<sup>16</sup> In the Order Instituting Proceedings ("OIP"), the Division of Enforcement alleges that EJR and Mr. Egan committed numerous violations of Sections 15E and 17(a) and the rules thereunder. The OIP specifically alleges that EJR made material misrepresentations and omissions in its initial application for NRSRO status and its annual certifications, including overstating EJR's qualifications with respect to rating asset-backed securities and government securities and inaccurately stating that EJR was not aware of its subscribers' holdings. The OIP also alleges that EJR failed to adequately disclose and manage conflicts of interest related to securities ownership by its employees, and in several instances EJR analysts participated in determining credit ratings of issuers in which they owned securities. Finally, the OIP alleges that EJR failed to make and retain records documenting the established procedures and methodologies it uses to determine credit ratings, as well as required records concerning the basis for its credit rating actions, the identity of personnel that participated in each credit rating action, whether the rating action was solicited or unsolicited, and certain types of communications concerning each credit rating.

The Commission received no complete initial applications for registration as an NRSRO during the reporting period.

For additional information on the status of registrants and applicants in prior reporting periods, please refer to prior annual reports in the Public Reports section of OCR's webpage at: <http://www.sec.gov/about/offices/ocr.shtml>.

## **IV. COMPETITION**

### **A. Select NRSRO Statistics**

The following sections summarize certain information reported by NRSROs registered with the Commission on Form NRSRO and Commission analyses of that information.

#### **1. NRSRO Credit Ratings Outstanding**

Of the nine NRSROs, six operate primarily under the "issuer-pay" model.<sup>17</sup> Two NRSROs, KBRA and Morningstar, previously operated primarily under the "subscriber-pay" model but in recent years have begun issuing an increasing number of ratings under the issuer-

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<sup>16</sup> *In the Matter of Egan-Jones Ratings Company and Sean Egan*, Release No. 66854 (April 24, 2012). The Commission's administrative proceeding is pending, with a hearing currently scheduled for later in 2012. In June 2012, EJR and Mr. Egan filed a complaint in Federal District Court seeking to have the Commission's administrative proceeding removed to Federal Court. *Egan-Jones Rating Co. v. S.E.C.*, 2012-cv-00920 (D.D.C. June 6, 2012). The Federal District Court case is also pending.

<sup>17</sup> A.M. Best, DBRS, Fitch, JCR, Moody's, and S&P.

pay model.<sup>18</sup> Only EJR operates fully under the subscriber-pay model. The NRSROs operating primarily under the issuer-pay model account for almost 99% of the total NRSRO credit ratings reported by NRSROs as of December 31, 2011.

The table below provides the number of outstanding credit ratings reported by each NRSRO, in its annual certification for the calendar year ending December 31, 2011, in each of the five categories identified in Section 3(a)(62) of the Exchange Act for which the NRSRO is registered.

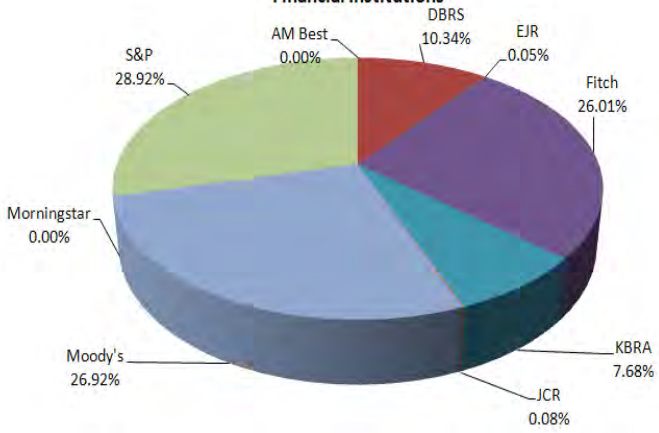
<b>Number of Outstanding Credit Ratings by Category of Credit Rating</b>						
<b>Source: NRSRO Annual Certifications for the Year Ended December 31, 2011</b>						
<b>NRSRO</b>	<b>Financial Institutions</b>	<b>Insurance Companies</b>	<b>Corporate Issuers</b>	<b>Asset-Backed Securities</b>	<b>Government Securities</b>	<b>Total Ratings</b>
<b>A.M. Best</b>	N/R	4,826	1,910	56	N/R	6,792
<b>DBRS</b>	21,695	151	4,037	9,889	15,798	51,570
<b>EJR</b>	101	51	962	13	9	1,136
<b>Fitch</b>	54,586	4,010	14,427	58,315	217,198	348,536
<b>JCR</b>	163	27	478	N/R	54	722
<b>KBRA</b>	16,127	52	1,001	40	58	17,278
<b>Moody's</b>	56,486	3,953	30,439	93,913	814,087	998,878
<b>Morningstar</b>	N/R	N/R	N/R	16,070	N/R	16,070
<b>S&amp;P</b>	60,700	7,800	45,400	108,400	948,300	1,170,600
<b>Total</b>	209,858	20,870	98,654	286,696	1,995,504	2,611,582

\*N/R indicates the NRSRO is not registered for that category of securities.

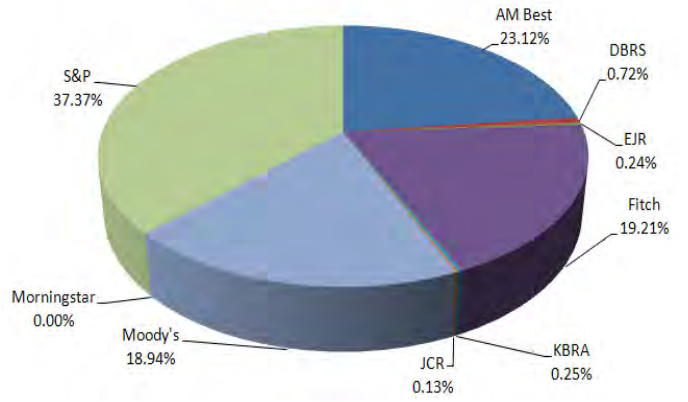
The pie charts below depict the percent of the credit ratings in total and in each category reported by all NRSROs as of December 31, 2011 that were attributable to each NRSRO. For example, per the above table, A.M. Best reported that it had 4,826 insurance company credit ratings, and the total of the credit ratings in that category reported by all NRSROs was 20,870. Dividing 4,826 by 20,870 = (approximately) 0.2312 or 23.12% (the proportion of NRSRO insurance company ratings attributable to A.M. Best).

<sup>18</sup> See Exhibit 2 to KBRA's Form NRSRO, as of its annual certification dated March 30, 2012, in which KBRA states that it offers issuer-paid ratings as well as subscriptions to its ratings and describes its process for determining each type of rating; See also Exhibit 2 to Morningstar's Form NRSRO, as of its annual certification dated March 31, 2012, in which Morningstar states that it generally issues ratings either as a rating agency selected and paid by the arranger or as a non-selected rating agency providing a final rating and surveillance to subscribers on a subscription-pay basis.

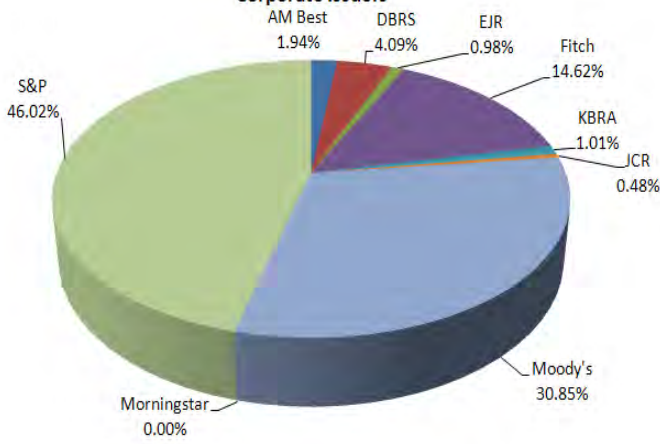
**Financial Institutions**



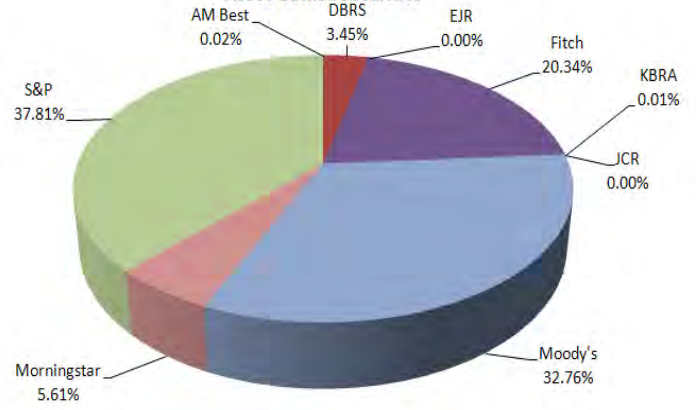
**Insurance Companies**



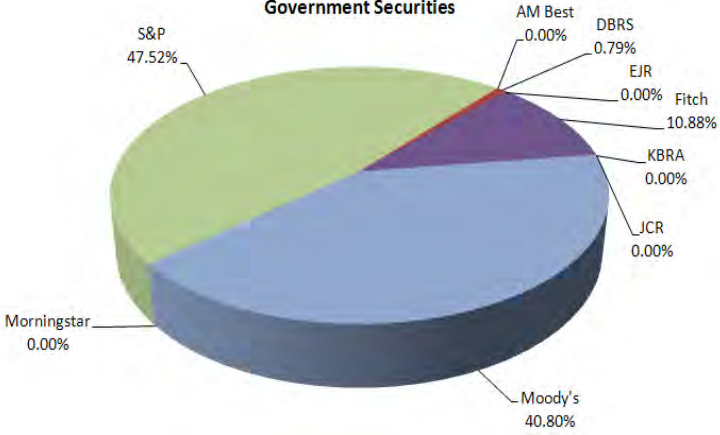
**Corporate Issuers**



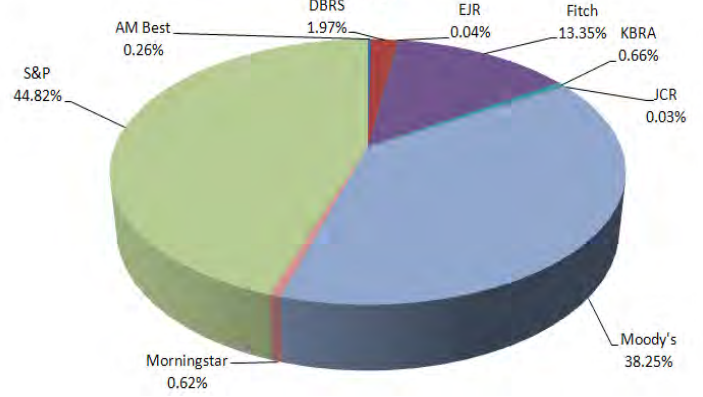
**Asset-Backed Securities**



**Government Securities**



**Total Ratings**





Moody's and S&P were the two largest NRSROs based on the number of credit ratings as of December 31, 2011, with approximately 1 million and 1.2 million ratings, respectively, and Fitch was the third largest with approximately 350,000 ratings. However, concentration was not consistent across rating classes. Moody's and S&P had the largest number of credit ratings of corporate issuers, asset-backed securities, and government securities. For credit ratings of financial institutions, Fitch and Moody's had substantially more ratings than S&P in the past. The gap narrowed in 2010 and, in 2011, S&P surpassed Fitch and Moody's in this class. Also in 2011, S&P had the largest number of credit ratings of insurance companies, with A.M. Best, Fitch and Moody's providing most of the remaining ratings in that class.

Two NRSROs, Moody's and S&P, accounted for approximately 83% of all credit ratings. Moody's, Fitch and S&P accounted for approximately 96% of all credit ratings (the top three accounted for 97% of all outstanding credit ratings in last year's report). The concentration of ratings for these three NRSROs is high across all five categories but varies across those categories. For instance, Fitch, Moody's, and S&P account for over 99% of all NRSRO ratings for government, municipal and sovereign securities<sup>19</sup>, but approximately 75% of all NRSRO ratings for insurance companies.<sup>20</sup> For various reasons, including those discussed below and in prior reports, market concentration must be considered together with other factors to identify the level of competition in a given market.

Some of the smaller NRSROs concentrate more on particular sectors or regions. For example, A.M. Best primarily rates insurance companies. Morningstar rates only ABS. KBRA has historically focused on rating financial institutions, although recently it has started to expand into other areas. JCR is based in Japan and issues ratings primarily on Japanese issuers and securities.

Among the smaller NRSROs, KBRA and DBRS reported having the largest number of ratings of financial institutions (16,127 and 21,695, respectively, or approximately 8% and 10%, respectively, of all ratings in this category). A.M. Best reported the largest number of ratings of insurance companies among the smaller NRSROs (4,826, or about 23%, of all ratings in this category) and DBRS reported the largest number of ratings of corporate issuers among the smaller NRSROs (4,037, or about 4% of all ratings in this category).

Of the 286,696 credit ratings of ABS, all but 26,068 (approximately 9%) were attributable to Fitch, Moody's, and S&P. Among the smaller NRSROs, Morningstar reported having the largest number of ratings of ABS (16,070, or approximately 6%, of all ratings in this category).

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<sup>19</sup> Fitch, Moody's, and S&P together accounted for 1,979,585 of the 1,995,504 outstanding NRSRO credit ratings in this category as of December 31, 2011.

<sup>20</sup> Fitch, Moody's, and S&P together accounted for 15,763 of the 20,870 outstanding NRSRO credit ratings in this category as of December 31, 2011.

## 2. Industry Concentration

Industry concentration, which is an indicator of the competitiveness of an industry, can be measured using the Herfindahl-Hirschman Index (“HHI”).<sup>21</sup> Additionally, the inverse of this number (“HHI inverse”) can be used to represent the number of equally sized firms necessary to replicate the amount of concentration in a particular industry. The HHI, based on the number of ratings for each NRSRO at the end of 2011, was calculated to be 3,655 (which constitutes a “concentrated” market), and is the equivalent of an industry with approximately 2.74 equally sized firms.<sup>22</sup> In last year’s report, the Commission calculated an HHI of 3,472, which is the equivalent of an industry comprised of approximately 2.88 equally sized firms. This is an indication that, as a whole, the level of market concentration has increased slightly.

However, industry concentration varies among the different classes of ratings. Government ratings (which include sovereign, municipal, and public ratings), is the most concentrated, with an HHI inverse of 2.47. This class also has the highest number of ratings (making up 76% of all ratings), which skews the aggregate HHI calculation. Excluding the government ratings from the HHI inverse calculation yields a result of 3.70, which indicates less industry concentration in the other rating classes. In last year’s report this number was calculated to be 3.55, reflecting that increased competition over the past year has led to a decrease in industry concentration for these classes.

The table below reports the HHI inverse calculated for the ratings outstanding in each class and in total for the years 2008 through 2011.

**HHI Inverse for Each Class of Ratings**

Year	Financial Institutions	Insurance Companies	Corporate Issuers	Issuers of Asset-Backed Securities	Issuers of Government Securities	Total
2008	3.72	4.05	3.79	2.82	2.83	2.99
2009	3.85	3.84	3.18	3.18	2.65	2.86
2010	3.99	3.37	3.17	3.20	2.69	2.88
2011	4.16	3.76	3.02	3.38	2.47	2.74

<sup>21</sup> Market concentration is generally measured using the Herfindahl-Hirschman Index, which is a measure of the size of firms in relationship to the industry and is an indicator of the amount of competition among them. It is calculated by taking the market share of each firm competing in the market, multiplying that proportion by 100 and squaring the result, and then summing the resulting numbers. The HHI is measured on a scale of 0 to 10,000 points and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size among those firms increases. According to the U.S. Department of Justice, markets in which the HHI is between 1,000 and 1,800 points are considered to be moderately concentrated, and those in which the HHI is in excess of 1,800 points are considered to be concentrated. See U.S. Department of Justice and the Federal Trade Commission, Horizontal Merger Guidelines § 5.2 (2010). The inverse of the HHI is an approximation of the number of equally sized firms which would constitute an equivalent level of concentration for a given HHI, and is calculated by dividing 10,000 by the HHI.

<sup>22</sup> If the nine firms each had an equal share (~11%) of the market, the HHI would be ~11 squared (equals ~ 123) times 9 = 1,111 points.

The largest annual change in 2011 occurred in the class of insurance company ratings where the HHI inverse rose from 3.37 in 2010 to 3.76 in 2011, indicating a lower level of market concentration. The change appears to have resulted primarily from an increase in the number of insurance company ratings reported by Fitch. Fitch reported 4,010 ratings of insurance companies in 2011, which was an increase from the 1,657 ratings it reported in the category in 2010.

Between 2008 and 2011, the HHI inverse for the ABS sector increased from 2.82 to 3.38. During this time period, the percentage of ABS ratings issued by Fitch, Moody's and S&P declined from 96% to 91%. Most of this decrease is related to lower ABS market share by S&P. S&P issued about 49% of all ABS ratings in 2008. By 2011, this percentage had decreased to 38%. Most of this decrease is related to lower ABS market share of S&P and a slight increase of the market share of DBRS, Morningstar and KBRA.

### **3. NRSRO Financial Results**

The total revenue<sup>23</sup> reported by all of the NRSROs for the most recent financial report made in the reporting period was approximately \$4.2 billion, which was essentially flat from the prior year.<sup>24</sup> The HHI based on total revenue reported by NRSROs is 3,265 points, the equivalent industry concentration of approximately 3 equally sized firms. The HHI based on net income reported by NRSROs is 3,788 points, the equivalent industry concentration of approximately 2.6 equally sized firms. The HHI based on net income indicates an increased level of concentration when compared to the HHI based on revenue because the firms which reported the largest amounts of revenue also tended to have higher after-tax profit margins. The net income amounts reported by the three largest NRSROs made up approximately 97% of the total net income reported by all of the NRSROs.

#### **B. The State of Competition among NRSROs**

##### **1. Barriers to Entry**

A wide range of private contractual agreements which reference the ratings of particular rating agencies create a potential barrier to entry for new entrants. These include, for example, minimum ratings requirements that require the ratings of specific rating agencies in the investment management contracts of institutional fund managers and the investment guidelines of fixed income mutual fund managers, pension plan sponsors, and endowment fund managers. In addition, fixed income indices used to evaluate the performance of investment managers often have inclusion characteristics which refer to the ratings of specific rating agencies. The effect of

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<sup>23</sup> Section 15E(k) of the Exchange Act requires each NRSRO to file, on a confidential basis, such financial statements and information concerning its financial condition as the Commission may prescribe by rule. Exchange Act Rule 17g-3 requires each NRSRO to provide the Commission with annual financial reports not more than 90 calendar days after the end of its fiscal year. In particular, Rule 17g-3(a)(1) requires NRSROs to provide audited financial statements, which must include a balance sheet, an income statement and statement of cash flows, and a statement of changes in ownership equity.

<sup>24</sup> Six NRSROs have fiscal years ending on December 31; others have fiscal years ending on March 31, September 30, or November 30.

these contractual agreements can be to increase the demand and liquidity for securities bearing the ratings of specific providers.

In addition, ratings triggers are commonly found in bank loan agreements, guaranteed investment contracts, and the credit support annexes and other provisions of derivatives contracts. When ratings triggers are present, a decline in the rating of an issuer or obligor below a certain level can alter the obligations of parties to an agreement. For example, a ratings trigger can provide a counterparty to a derivatives contract the right to demand collateral or lenders with the right to demand repayment of a loan. The ratings of specific rating agencies are often specified in such agreements.

Additionally, certain statutory and regulatory limitations may create a potential barrier to entry for new entrants. For example, only certain NRSROs were recognized during the reporting period for purposes of satisfying rating requirements of underwriter exemptions, which permit ERISA plans to purchase certain investment grade structured finance securities.<sup>25</sup> In Europe, only certain credit rating agencies were recognized during the reporting period for purposes of providing external credit assessments to determine the risk weight of an institution's exposures.<sup>26</sup>

## 2. Newer and Smaller Entrants Gain Market Share

Some of the newer and smaller NRSROs have increased their market share in the past few years in a sector of the structured finance market, specifically the commercial mortgage-backed securities ("CMBS") market. According to Commercial Mortgage Alert's mid-year and full-year rating agency rankings, KBRA and Morningstar, both newer entrants to the issuer-pay CMBS market, have gained market share in the past few years. Morningstar's market share increased from 15% in 2010 to 23% in the first half of 2012. KBRA, which first began issuing ratings on CMBS in 2011, had a market share of approximately 44% in the first half of 2012.<sup>27</sup> DBRS, which is not new to the CMBS market but is one of the smaller NRSROs, also increased its market share. DBRS' market share grew from approximately 20% in 2010 to approximately 38% in the first half of 2012.

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<sup>25</sup> See the grant of individual exemptions issued by the U.S. Department of Labor, Employee Benefits Security Administration, from certain of the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974, available at: <http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=22833&AgencyId=8&DocumentType=3>

<sup>26</sup> See the revised guidelines on the recognition of External Credit Assessment Institutions, Committee of European Banking Supervisors (Nov. 30, 2010), available at <http://www.eba.europa.eu/cebs/media/Supervisory-disclosure/Revised-Guidelines-ECAIS.pdf>.

<sup>27</sup> <http://www.cmalert.com/ranks.php>.

Rating Agencies for CMBS Issued in the First Half of 2012										
Rank	NRSRO	1H-2012 <sup>28</sup> Issuance (\$Mil.)	No. of deals	Market Share (%) <sup>29</sup>	1H-2011 Issuance (\$Mil.)	No. of deals	Market Share (%)	2010 Issuance (\$Mil.) <sup>30</sup>	No. of deals	Market Share (%)
1	Moody's	\$17,831.4	23	88.7	\$13,190.9	13	67.5	\$9,761.1	17	66.8
2	Fitch	11,787.5	19	58.6	13,847.2	13	70.9	8,260.4	11	56.5
3	Kroll	8,897.4	10	44.2	410.0	1	2.1	Not listed for 2010		
4	DBRS	7,711.4	12	38.3	4,991.2	7	25.6	2,936.2	3	20.1
5	Morningstar <sup>31</sup>	4,632.4	8	23.0	4,516.1	8	23.1	2,195.1	5	15.0
6	S&P	2,546.4	5	12.7	6,544.2	8	33.5	9,285.6	14	63.5
	<b>TOTAL</b>	<b>20,110.5</b>	<b>32</b>	<b>100.0</b>	<b>19,533.1</b>	<b>25</b>	<b>100.0</b>	<b>14,616.1</b>	<b>29</b>	<b>100.0</b>

Source: *Commercial Mortgage Alert*

For additional information on various aspects of competition in the industry, please see the discussion<sup>32</sup> in the March 2012 annual report in the Public Reports section of OCR's webpage at: <http://www.sec.gov/about/offices/ocr.shtml>.

## V. TRANSPARENCY

Congress described the Rating Agency Act as an act to improve ratings quality “by fostering accountability, transparency, and competition in the credit rating agency industry.”<sup>33</sup> Similarly, Section 932 of the Dodd-Frank Act is titled “Enhanced regulation, accountability, and transparency of NRSROs.” Both Acts contain various provisions designed to increase the transparency—through clear disclosure open to public scrutiny—of, among other things, NRSROs' credit rating procedures and methodologies, business practices, and credit ratings performance.

The Rating Agency Act added Section 15E(a)(3) of the Exchange Act,<sup>34</sup> which requires the Commission to issue rules requiring an NRSRO to make certain information publicly

<sup>28</sup> First half of 2012.

<sup>29</sup> Market share is calculated using total dollar issuance.

<sup>30</sup> Full-year data.

<sup>31</sup> Listed as Realpoint in 2010.

<sup>32</sup> See Demand for Ratings, Regulatory and Economic Factors that Potentially Affect Competition in the Credit Rating Industry, The State of Competition among NRSROs, Assessing the Impact of Additional Competition, and The Potential Impact of Competition of NRSRO Rules.

<sup>33</sup> See the preamble to the Rating Agency Act.

<sup>34</sup> 15 U.S.C. 78o-7(a)(3).

available on its website or through another comparable, readily accessible means. Exchange Act Rule 17g-1(i)<sup>35</sup> specifies that the information consists of the NRSRO's current Form NRSRO and Exhibits 1 through 9 to Form NRSRO. These exhibits contain the following information about each NRSRO:

- performance statistics;
- procedures and methodologies for determining credit ratings;
- procedures to prevent the misuse of material, non-public information;
- organizational structure;
- code of ethics (or an explanation as to why the NRSRO does not have a code of ethics);
- conflicts of interest;
- procedures to manage conflicts of interest;
- credit analysts; and
- designated compliance officers.<sup>36</sup>

Links to Form NRSRO and Exhibits 1 through 9 for each NRSRO are available on OCR's webpage at: <http://www.sec.gov/about/offices/ocr.shtml>.

The Dodd-Frank Act contained a number of provisions relating to NRSRO transparency. For additional information on rules and provisions related to NRSRO transparency, please see the discussion in the March 2012 annual report in the Public Reports section of OCR's webpage at: <http://www.sec.gov/about/offices/ocr.shtml>.

## **VI. CONFLICTS OF INTEREST**

Credit rating agencies operate under one of two business models (or a combination of them), and there are potential conflicts of interest inherent in both. As discussed above, the business model of the largest NRSROs is an "issuer pay" model, which means that, for example, an issuer of bonds pays the rating agency to rate its bonds. This "issuer-pay" model is subject to a potential conflict in that, if the bond issuer can "shop" for another rating by a different rating agency, the NRSRO, to gain favor with the issuer and retain its business, may issue a credit rating that is higher than the NRSRO's objective analysis would otherwise determine. This conflict could spread to an entire asset class if, for example, an NRSRO becomes known for issuing higher credit ratings with respect to a particular class of assets, resulting in that NRSRO retaining or attracting business from most or all issuers of securities backed by such asset class.

The other business model is the "subscriber-pay" model, which means that investors pay the rating agency a subscription fee to access its ratings. This model too is subject to potential conflicts of interest, albeit perhaps to a lesser degree. For example, the NRSRO may be aware

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<sup>35</sup> 17 CFR 240.17g-1(i).

<sup>36</sup> The Commission's examination staff reviews the quality and accuracy of an NRSRO's disclosures during an examination of an NRSRO. Prior to the implementation of the Commission's NRSRO registration and oversight program, certain credit rating agencies disclosed some of this information, particularly with respect to credit rating performance statistics and their procedures and methodologies for determining credit ratings.

that an influential subscriber holds a securities position (long or short) that could be advantaged if a credit rating upgrade or downgrade causes the market value of the security to increase or decrease; or that the subscriber invests in newly issued bonds and would obtain higher yields if the bonds were to have lower ratings. In another example, the NRSRO may be aware that a subscriber wishes to acquire a particular security but is prevented from doing so because its credit rating is lower than internal investment guidelines or an applicable contract permit. An upgrade of the credit rating of the security by the NRSRO could remove this impediment to investing in the security. These potential conflicts are mitigated, however, to the extent that subscribers have different interests with respect to an upgrade or downgrade of a particular security.

Other potential conflicts are common to both business models. For example, an employee of the NRSRO may have an ownership interest in an issuer that is subject to a credit rating of the NRSRO.<sup>37</sup> Another potential conflict may arise when a credit analyst who participated in rating an issuer was also seeking employment with the issuer.

The Dodd-Frank Act contained several provisions that address conflicts of interest. For additional information on rules and provisions related to NRSRO conflicts of interest, please see the discussion in the March 2012 annual report in the Public Reports section of OCR's webpage at: <http://www.sec.gov/about/offices/ocr.shtml>.

## **VII. CONCLUSION**

The Commission will continue to engage in rulemaking and other initiatives with respect to NRSROs to implement mandates of the Dodd-Frank Act and to otherwise enhance its oversight of NRSROs.

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<sup>37</sup> Rule 17g-5(c)(2) (17 CFR 240.17g-5(c)(2)) prohibits an NRSRO from issuing or maintaining a credit rating with respect to an issuer where the NRSRO, a credit analyst who participated in determining the rating, or a person responsible for approving the rating has any direct ownership interest in the issuer.