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Securities Enforcement Alert

S&P Receives a One-Year Suspension for MBS Ratings Misconduct

On January 21, 2015, the US Securities and Exchange Commission brought charges for the very first time against a major rating agency, sanctioning Standard & Poor's Rating Services (S&P) for making misrepresentations and failing to maintain accurate records and controls concerning its rating of certain commercial and residential mortgage-backed securities (CMBS and RMBS). Those sanctions include a one-year ban from rating any new issue US conduit/fusion CMBS transactions and $77 million in payments to the SEC and to the New York State and Massachusetts attorneys general.

S&P's Rating of Conduit/Fusion CMBS

Beginning in 2009, S&P issued new criteria for rating conduit/fusion CMBS transactions (i.e., CMBS transactions involving a pool of multiple loans that are diversified by both property type and geography). Specifically, S&P used the debt service coverage ratio (DSCR) — a property's annual net operating income divided by the annual mortgage debt service — to estimate whether the underlying mortgage loans would default during their term. S&P then used that estimate to determine the amount of credit enhancement it would require to achieve each rating level.

In December 2010, the S&P CMBS group relaxed the assumptions used to calculate DSCR, which generally resulted in higher DSCRs and, therefore, lower credit enhancement requirements. That new methodology was meant to be more attractive to CMBS issuers seeking lower credit enhancement levels. But, according to the SEC, while S&P was applying the new methodology to conduit/fusion CMBS transactions in 2011, it was simultaneously representing to investors in presale reports that it was using the older, more conservative methodology. The SEC order states that the S&P CMBS group also misrepresented its DSCR calculations in certain internal documents.

When potential investors questioned the low level of credit enhancements for the AAA bonds in one of two CMBS transactions in July 2011, S&P senior management reviewed both transactions, discovered that the S&P CMBS group was applying the new DSCR methodology, and withdrew the ratings on those transactions. S&P later disclosed the new methodology in August 2011, but maintained that the July 2011 transaction ratings were consistent with S&P's rating definitions.

In June 2012, in an effort to re-enter the conduit/fusion CMBS rating market after pulling its ratings for the July 2011 transactions, S&P published an article regarding proposed new CMBS rating criteria. Among other things, the article proposed a AAA credit enhancement level of approximately 20 percent (S&P used a 19 percent benchmark in 2011), purportedly based on an analysis of commercial real estate bond defaults and losses during the Great Depression. However, the article failed to disclose that: (i) some of the losses and defaults S&P considered did not in fact occur during the Great Depression; (ii) the data S&P used applied a discounting factor contrary to industry standards, which lowered loss estimates; and (iii) S&P excluded defaulted commercial mortgages that took longer than three years to resolve. The S&P senior criteria officer who conducted the analysis raised concerns that it did not support a 20 percent credit enhancement benchmark, but S&P published the article anyway.

The Commission's Cease-and-Desist Orders

On January 21, 2015, the Commission issued a series of four orders sanctioning S&P for violating the securities laws with respect to its rating of CMBS and RMBS transactions and initiating an administrative proceeding against S&P's former CMBS group chief Barbara Duka for misconduct with respect to rating CMBS transactions.[1] This is the first time the Commission has brought charges against a major nationally recognized statistical rating organization (NRSRO) such as S&P.

In the first order, the Commission found that S&P violated the antifraud provision, Section 17(a)(1), of the Securities Act of 1933 (Securities Act) because its statements to investors in presale reports were knowingly or recklessly false and misleading concerning the methodology S&P applied to rate the transactions. It additionally found that S&P failed to maintain a system of internal controls regarding its rating criteria in violation of Section 15E(c)(3) of the Securities Exchange Act of 1934 (Exchange Act). Among other things, S&P failed adequately to investigate an anonymous complaint it received in January 2011 concerning the new DSCR calculation methodology. Based on the foregoing — combined with books and records violations — S&P agreed to a one-year suspension from making preliminary or final ratings for any new issue US conduit/fusion CMBS transactions, a censure, and to pay the Commission $42 million in disgorgement and penalties. This suspension does not apply to surveillance of outstanding conduit/fusion CMBS issues that S&P had previously rated. The Commission also required S&P to admit certain facts underlying the Commission's fraud finding, including that the rating methodology disclosed to investors in 2011 did not match the one S&P used.

[1] *See* "SEC Announces Charges Against Standard & Poor's for Fraudulent Ratings Misconduct," Release No. 2015-10.

In the second order, the Commission found that S&P violated Section 17(a)(1) of the Securities Act because the statements regarding the Great Depression analysis in its June 2012 article proposing new rating criteria were knowingly or recklessly false and misleading. The Commission also found that S&P failed to maintain accurate books and records. As a result, S&P agreed to retract its Great Depression article and to revise other publications accordingly, in addition to agreeing to a censure and a $15 million penalty.

The third order concerned S&P's failure to follow its internal policies and procedures for applying the appropriate loss severity assumptions to be used in surveilling certain RMBS ratings. S&P also erroneously produced inconsistent external disclosures about its loss severity assumptions. The Commission found that S&P had deficient internal controls in violation of Section 15E(c)(3)(A) of the Exchange Act and that it failed to make and retain adequate records. But in light of the fact that S&P self-reported the RMBS rating issue and took voluntary steps to remediate it, the Commission levied only a $1 million penalty against S&P and did not require any admissions.

The fourth order initiated administrative proceedings against Duka, characterizing her as the architect of the fraudulent scheme to alter the CMBS rating criteria and to misrepresent that criteria to investors. The order suggested that Duka orchestrated the scheme and withheld information about her actions from senior S&P personnel. Duka is contesting the SEC's allegations, and has sought in a separate proceeding to remove the SEC proceeding from administrative court to federal district court.[2]

Key Takeaways

The SEC's charges against S&P and Duka are noteworthy for several reasons. First, as discussed, these are the first charges the SEC has filed against a major rating agency.

Second, CMBS issuers should understand what S&P's suspension covers and how it might affect their business. The suspension, which ends on January 22, 2016, prohibits S&P from making preliminary or final ratings for any new issue US conduit/fusion CMBS transaction and any marketing activity related to such a transaction. It does not prohibit S&P from engaging in surveillance of outstanding conduit/fusion CMBS issues that S&P has previously rated, nor does it encompass non-conduit/fusion CMBS transactions such as single-borrower transactions.

Finally, rating firms should consider enhancing internal controls and procedures for reviewing the methodologies used to rate securities and for identifying red flags concerning the faulty application of those methodologies. Although the SEC's orders strongly suggest that Duka was responsible for the CMBS rating misrepresentations, the SEC nevertheless charged S&P with

[2] *See Duka v. US Sec. Exch. Comm'n*, No. 15-cv-357 (S.D.N.Y. filed Jan. 16, 2015).

fraud and required S&P to admit certain facts underlying that charge. That is likely due in large part to S&P's failure to conduct a sufficient investigation into how the CMBS group assigned its ratings even after it received an anonymous complaint about that group's rating methodology. Firms should take such complaints seriously and involve compliance and legal professionals as soon as practicable in order to quickly identify and remediate potential issues.

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