

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 62968 / September 22, 2010

Admin. Proc. File No. 3-13860

In the Matter of the Application of

DAGONG GLOBAL CREDIT RATING CO., LTD.

c/o Philip Nelson Lee
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555 South Flower Street, Forty-First Floor
Los Angeles, CA 90071

For Review of Application for Registration as NRSRO

ORDER DENYING
APPLICATION FOR
REGISTRATION AS A
NATIONALLY RECOGNIZED
STATISTICAL RATING
ORGANIZATION

I.

Section 15E of the Securities Exchange Act of 1934 and related rules prescribe the process by which credit rating agencies may apply to the Commission for registration as Nationally Recognized Statistical Rating Organizations ("NRSROs") and the requirements to which NRSROs must adhere if they become so registered.¹ On December 24, 2009, Dagong Global Credit Rating Co., Ltd. ("Dagong"), a credit rating agency located in the People's Republic of China ("China"), submitted an application for registration as an NRSRO. Exchange Act Section 15E(a)(2)(A) requires the Commission, not later than ninety days after a rating agency furnishes its application for NRSRO registration, to either grant that application or institute proceedings to determine whether the request should be denied.²

¹ See 15 U.S.C. § 78o-7; 17 C.F.R. §§ 240.17g-1 *et seq.* Registration as an NRSRO is voluntary and confers upon the registrant certain regulatory benefits. For example, the credit ratings of an NRSRO are used to assess the creditworthiness of obligors and debt instruments under the securities laws, U.S. banking regulations, state insurance regulations, and U.S. student loan legislation.

² Dagong consented to two short extensions of time, totaling twenty-one days, to assist Commission staff in considering whether to grant Dagong's application or institute proceedings to determine whether the application should be denied.

On April 14, 2010, we issued an order instituting proceedings to determine whether Dagong's application should be denied.³ In that order, we directed the parties to submit briefs addressing issues of law or fact in dispute and noted that the possible grounds for denial included: (1) whether Dagong has sufficient connection with U.S. interstate commerce to register as an NRSRO and invoke our regulatory and oversight authority; and (2) whether Dagong, if registered as an NRSRO, would be unable to comply with those provisions of the federal securities laws and rules that require registrants to create and maintain certain records that are subject at any time to Commission examination and that must be furnished to the Commission upon request. Dagong and the Commission's Division of Trading and Markets (the "Division") have submitted briefs in response to that order, and each attached several documents in support of its position.⁴ Neither party objected to any documents submitted by the other. Having considered all these submissions, we find that we must deny Dagong's application because, irrespective of the jurisdictional question, it does not appear possible at this time for Dagong to comply with the recordkeeping, production, and examination requirements of the federal securities laws.

II.

A. **Dagong's application for NRSRO status**

Dagong was formed in 1994 and is the largest credit rating agency in China. Dagong is headquartered in Beijing and has more than two dozen branch offices throughout China, but it currently has no office in the United States.⁵ Dagong is licensed to operate as a credit rating institution by the China Securities Regulatory Commission ("CSRC") and is subject to its oversight, rules, and regulations. Dagong represents that it rates the credit of several Chinese companies that are listed on stock exchanges in the United States and that several American companies have used Dagong's Web site to consult its ratings.

³ See Order Instituting Administrative Proceedings Pursuant to Section 15E(a)(2)(A)(ii) of the Securities Exchange Act of 1934 and Notice of Hearing, Securities Exchange Act Rel. No. 61906 (Apr. 14, 2010), 98 SEC Docket 27376.

⁴ In the course of that briefing, Dagong requested two extensions of time totaling forty-two days and, to facilitate those requests, consented to extend by a reasonable amount of time the deadline by which the Commission must conclude these proceedings. As a result, the deadline for conclusion of these proceedings was established as September 23, 2010.

⁵ Dagong represents that it intends to open an office in New York once it obtains NRSRO status.

B. OIA's efforts to clarify the CSRC's position with respect to the Commission's ability to inspect Dagong's records

At the request of the Division, the Commission's Office of International Affairs ("OIA") exchanged several letters with the CSRC from March to May 2010, inquiring about Dagong's ability to comply with the federal securities laws and regulations applicable to NRSROs.⁶ First, on March 10, 2010, OIA wrote a letter to the CSRC explaining that NRSROs are required by applicable laws and regulations to (1) allow Commission staff to conduct on-site reviews of the firm's books and records; (2) produce to Commission staff copies of the firm's books and records; and (3) furnish such reports as Commission staff deems necessary. The letter asked the CSRC to confirm that, under domestic Chinese law, Dagong would be able to comply with these requirements.

By letter dated March 26, 2010, the CSRC responded that the issue of on-site visits for examination of an NRSRO would require an arrangement between the Commission and the CSRC after the CSRC resolved an issue regarding the inspection of Chinese accounting firms by the Public Company Accounting Oversight Board ("PCAOB").⁷ The CSRC's response did not address OIA's questions about the production of documents and reports.

On April 14, 2010, OIA responded to the CSRC, pointing out that the CSRC's March 26 letter was silent on the issue of whether Dagong would be able to provide documents to the Commission in response to requests. OIA also noted that it had informed the Division that the CSRC had been unable to confirm that Dagong would, under Chinese law, be able to produce directly to the Commission information it required as part of its ongoing supervision and regulation of an NRSRO. The CSRC responded by letter on May 10, 2010, stating that, because Dagong did not conduct any significant business in the United States, the CSRC "[did] not see any short-term necessity" for the Commission to conduct on-site inspections or review Dagong's "working papers." The CSRC reiterated its position that the resolution of issues arising from

⁶ The description of the correspondence between OIA and the CSRC derives from a memorandum prepared by the Director of OIA on May 14, 2010, which was attached to the Division's opening brief. The original letters were not included in the record before us due to the confidential nature of correspondence with foreign regulators. Dagong has not taken any exception to the OIA memorandum or its description of events.

⁷ In December 2008, the PCAOB sought public comment on how sovereignty concerns should influence its disciplinary process if a non-U.S. accounting firm is prevented by local law from complying with its inspection requests. The CSRC took the position that, "under the current Chinese laws and regulations, PCAOB is not allowed to perform any form of independent or joint on-site inspection in the Chinese territory," while expressing the desire to continue working together to "safeguard our cross-border financial activities." *See* Comment Letter from Dr. Daochi Tong, Director-General, Department of International Affairs, and Zhonghui Zhou, Chief Accountant, China Securities Regulatory Commission (Jan. 22, 2009) *available at* http://pcaobus.org/Rules/Rulemaking/Docket%20027/024_Csrc.pdf.

Dagong's NRSRO application were contingent upon resolving its concerns with the PCAOB about the inspection of Chinese accounting firms.

C. Dagong's view of its ability to comply with applicable law

At the request of Division staff during its consideration of Dagong's application, Dagong submitted a letter on March 10, 2010, expressing its intention to comply with the rules and regulations applicable to an NRSRO if it were to be so designated. In that letter, Dagong's president acknowledged that Dagong, as an NRSRO, would be subject to the document production provisions of Exchange Act Section 17(b) and related rules. The letter explained that Dagong would make a "good-faith effort" to comply with those rules, subject to the requirements of Chinese law:

Dagong intends to make a good-faith effort to comply with such rules and to produce such documents for examination and inspections as may be requested by the Commission, subject, however, to Dagong's compliance with the laws, rules and regulations of the People's Republic of China and the [CSRC] or such other appropriate Chinese regulatory authority.

In its opening brief, Dagong explained how the Commission would have access to Dagong's records in practice: "The Commission shall send the required document list first to the CSRC, and then the CSRC will collect the documents on behalf of the Commission." The documents would then be translated, Dagong noted. Dagong further explained that the document production would be subject to provisions in Chinese law that prohibit the disclosure of documents containing "state secrets or [information of] vital interest to relevant securities companies" without approval from the CSRC, China's State Archives Administration, the Administration for the Protection of State Secrets, or "other relevant authorities."

III.

A. Applicable law

Exchange Act Sections 15E(a)(2)(C)(ii)(II), 15E(d), and 15(b)(4)(D) provide that we must deny a credit rating agency's application for NRSRO status if the applicant would be subject to having its registration suspended or revoked because it is "unable to comply" with any provision of the securities laws and related rules.⁸ Among other things, Dagong must be able to comply with provisions in the Exchange Act and related rules that pertain to the Commission's examination of Dagong's records and Dagong's obligation to produce information to the Commission.

Exchange Act Section 17(b)(1) provides, in relevant part, that "all records" of NRSROs (as well as national securities exchanges, broker-dealers, and certain other regulated entities)

⁸ 15 U.S.C. §§ 78o-7(a)(2)(C)(ii)(II); 78o-7(d); 78o(b)(4)(D).

are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission . . . as the Commission . . . deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Exchange Act].⁹

In addition, Exchange Act Rule 17g-2 requires NRSROs to create and retain certain records, including, for example, records regarding the identities of credit analysts who participate in ratings; the identities of persons paying for the ratings; compliance reports; internal audit plans and reports and supporting documentation; credit analysis reports ("including non-public information and work papers, used to form the basis for the opinions expressed in these reports"); and external and internal communications relating to the NRSRO's initiation, determination, maintenance, change, or withdrawal of a credit rating.¹⁰ The rule also provides that NRSROs "must promptly furnish the Commission or its representatives with legible, complete, and current copies, and, if specifically requested, English translations" of those records required by rule to be created and maintained.

B. Dagong's proposal for inspection and production of documents and reports is too restrictive to comply with securities laws and rules

Dagong's management represented that it "intends to make a good-faith effort" to comply with the recordkeeping and production requirements applicable to NRSROs but acknowledged that the extent of its compliance would be potentially limited by its concurrent obligation to comply with domestic laws and regulations. We credit Dagong's statement that it intends to make a sincere effort to comply with our oversight requirements.¹¹ However, on the record before us, it appears that Dagong would not control what information would be produced to Commission staff. As an initial matter, we are unable to conclude that Dagong can comply with the recordkeeping, production, and inspection requirements of the Exchange Act because the CSRC has taken the position that it does not see "any short-term necessity" for the Commission to review Dagong's "working papers."

⁹ 15 U.S.C. § 78q(b)(1).

¹⁰ 17 C.F.R. § 240.17g-2(a), (b).

¹¹ In its brief, Dagong states that the "good-faith letter" "was not an attempt to express reservations or highlight inconsistency between Chinese and U.S. laws and rules." We acknowledge that Dagong provided the letter in an attempt to demonstrate that it wished to comply with applicable U.S. law and also that Dagong was not required by law to provide such assurances during the application process. Regardless, as noted above, the letter is useful evidence of Dagong's understanding of the competing regulatory frameworks within which it conducts business.

Moreover, we find that the process Dagong proposes for document production and inspection does not meet the requirements of Exchange Act Section 17(b) and related rules. As Dagong explained in its brief, Commission staff must submit its document requests not to Dagong but to the CSRC, which would interpret the request, collect from Dagong those documents it deems responsive to the request, and remove any information that contains "state secrets" before sending them to the staff. However, under the Exchange Act and Rule 17g-2, the NRSRO must promptly provide complete documents to the Commission and permit our access to them. The nature of the review we must conduct – *e.g.*, determining whether an NRSRO is following its disclosed policies for preventing misuse of material non-public information or for managing conflicts of interest – requires broad access to documents. The Exchange Act further requires the Commission to examine NRSRO records it deems necessary or appropriate in the public interest and in furtherance of the purposes of the Act.¹²

The CSRC has stated that the Commission should "entrust" the CSRC to "implement" the Commission's oversight of Dagong, and Dagong notes that the two regulators have a common interest in overseeing Dagong's rating activities and share grounds for cooperation in that regard. It urges the Commission to permit the CSRC to administer its document production in accordance with the provisions of existing international arrangements.¹³ We recognize the critical importance of cooperation with non-U.S. financial regulators to achieve effective cross-

¹² See Exchange Act Section 15E(c)(1), 15 U.S.C. § 78o-7(c)(1) ("The Commission shall have exclusive authority to enforce the provisions of this section in accordance with this title"); *cf. Citizens Council of Del. Cty. v. Brinegar*, 619 F. Supp. 52 (E.D. Pa. 1985) (noting that, even where a statute permits an agency to delegate functions, some limitation on the ability to delegate is still necessary to prevent "those charged with responsibility by Congress [from] wholly abdicat[ing] that responsibility and frustrat[ing] the intent of Congress and the policy of the Act in question") (citing *Nat'l Small Shipments Traffic Conference, Inc. v. Interstate Commerce Comm'n.*, 725 F.2d 1442, 1450-51 (D.C. Cir. 1984)).

¹³ There are three international arrangements between the Commission and the CSRC, none of which is designed to cover cooperation in the supervision and oversight of cross-border regulated entities: (1) the Memorandum of Understanding Concerning Cooperation, Consultation and the Provision of Technical Assistance, which is aimed at facilitating the provision of technical assistance and training by Commission staff to the CSRC and includes a general statement of intent by the Commission and the CSRC to assist one another in cross-border matters involving suspected violations of law; (2) the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, a global information-sharing arrangement among securities regulators in securities enforcement matters, under which the provision of assistance is predicated on a suspected violation of securities laws in the requesting regulator's jurisdiction and is limited to providing bank, brokerage, and beneficial ownership records as well as information in a regulator's files; and (3) the Terms of Reference for Cooperation and Collaboration, which establishes the parameters for a high-level bilateral regulatory dialogue between the two agencies and provides for periodic meetings at the staff and Chairs' level to discuss issues of common interest.

border oversight and enforcement of securities laws. However, none of these arrangements is designed to cover cooperation in the supervision and oversight of cross-border regulated entities. In particular, the existing arrangements do not contemplate access to non-public supervisory information located abroad or cooperation in on-site inspections of regulated entities located abroad, instead focusing on training and technical assistance, information sharing in the context of a suspected violation of law, and the discussion of approaches to common regulatory issues. In any event, the existing arrangements do not authorize the delegation of oversight responsibilities from one regulator to another.

Dagong maintains that the CSRC's role "is not an impediment to the Commission's oversight obligations" because that oversight is focused generally on whether the NRSRO has accurately disclosed information regarding its procedures and methodologies in issuing credit ratings – topics that Dagong believes would not implicate those "issu[es] of national security, confidential[ity,] and state secrets" that would trigger the CSRC to withhold information. However, Dagong does not define "state secrets" in its briefs and suggests that domestic law permits withholding information of "vital interest" to "relevant securities companies." And Dagong does not explain what, if any, mechanism would exist to inform the Commission as to what information was withheld and the basis for withholding it. That potential information vacuum undermines the purposes of the NRSRO examination requirement.¹⁴

Complicating matters further is the CSRC's position that it will permit no on-site inspections of Dagong until the CSRC resolves its disagreement with the PCAOB over an analogous issue. Dagong argues that Rule 17g-2 "is intended to provide for oversight without Commission staff going to do physical plant inspections." In support of its argument, Dagong

¹⁴ As the Commission explained in the release accompanying the adoption of Exchange Act Rule 17g-2:

The Commission believes [Rule 17g-2] is necessary or appropriate in the public interest or for the protection of investors and narrowly tailored to achieve its purpose. The Commission designed the rule based on its experience with recordkeeping rules for other regulated entities. The other books and records rules have proved integral to the Commission's investor protection function because the preserved records are the primary means of monitoring compliance with applicable securities laws. Rule 17g-2 is designed to ensure that an NRSRO makes and retains records that will assist the Commission in monitoring, through its examination authority, whether an NRSRO is following its disclosed procedures and methodologies for determining credit ratings, its disclosed policies and procedures for preventing the misuse of material nonpublic information, and managing conflicts of interest, and whether it is complying with Rules 17g-4, 17g-5, and 17g-6

cites to the final rule release for Rule 17g-2 in which we noted that the requirement for NRSROs to produce documents to the Commission "was designed to provide a mechanism for the Commission to inspect records maintained overseas without having to travel to the location."¹⁵ However, although document production by NRSROs is one tool with which we fulfill our oversight obligations, nothing in Exchange Act Rule 15E or Rule 17g-2 defines document production as the exclusive means of oversight. To the contrary, as noted previously, Exchange Act Section 17(b)(1) provides that records of NRSROs are subject to such "other examinations . . . as the Commission . . . deems necessary" and does not distinguish between foreign or domestic NRSROs.¹⁶

C. Dagong's further arguments

Dagong objects to what it perceives as the inappropriate conflation of its application for NRSRO registration with the PCAOB's ability to conduct on-site inspections of registered public accounting firms that are located in China. We recognize that the regulatory frameworks for NRSROs and PCAOB member firms are distinct. The discussions between the CSRC and PCAOB, however, raised concerns for Commission staff about whether the CSRC would take a similar position with respect to examinations of NRSROs. When the staff followed up on those concerns, the position of the CSRC with respect to Dagong – *i.e.*, that the CSRC will not currently permit Commission staff to conduct on-site inspections of Dagong and sees no immediate need for the staff to examine its records – indicated that Dagong is unable to comply with the recordkeeping, examination, and production requirements applicable to NRSROs, as we discussed above.

Dagong argues that "many Chinese companies are registered with the Commission and that they in fact provide information to the Commission on a regular basis. There is no reason to believe that an NRSRO cannot do the same." However, the ability of Chinese companies registered under other provisions of the securities laws to discharge their disclosure and reporting obligations does not bear on Dagong's ability to comply with oversight requirements applicable to NRSROs.

¹⁵ *Id.* at 33,590.

¹⁶ *See supra* note 9 and accompanying text. We note that Commission staff currently makes extensive use of on-site data collection in its examinations of resident NRSROs. *See* "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies," p. 3 (July 8, 2008), *available at* <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> ("The examinations included extensive on-site interviews with the rating agencies' staff, including senior and mid-level managers, initial ratings analysts and surveillance analysts, internal compliance personnel and auditors, personnel responsible for building, maintaining and upgrading the ratings models and methodologies used in the ratings and other relevant rating agency staff" in addition to reviewing "a large quantity" of the agencies' records).

Dagong also argues that the Commission "must assume" that Dagong, if granted NRSRO status, "will continue to comply with requests for information" in the same way that it has supplied information in support of its NRSRO application. However, the documents required to conduct an examination are not necessarily similar in kind or content to the documents Dagong has so far submitted in support of its application and, as noted above, under the proposed framework, Dagong's supervisory authority, and not Dagong, would manage the process of identifying, collecting, and producing documents for inspection. Therefore, Dagong's prior document submissions in this matter do not establish that it could comply with the inspection and production requirements of the Exchange Act and related rules.

Dagong also suggests that the Commission should grant its application because, in the event Dagong eventually fails to comply with the securities laws, "the Commission has the power and the authority to deregister [Dagong]" at a later time. However, Section 15E does not contemplate this kind of approach. To the contrary, Section 15E *requires* the Commission to reject a credit rating agency's application if the agency cannot comply with the federal securities laws at the time when the Commission considers its application for registration as an NRSRO.¹⁷

We must, therefore, deny Dagong's application for NRSRO status. At this time, we cannot conclude that Dagong is able to comply with the Exchange Act's recordkeeping, production, and examination requirements. Because we find that Dagong is currently unable to

¹⁷ See Exchange Act Section 15E(a)(2)(C)(ii), 15 U.S.C. § 78o-7(a)(2)(C)(ii) (providing that the Commission shall grant an NRSRO application unless it finds that, if the applicant were registered as an NRSRO, its registration would be subject to suspension or revocation – "in which case the Commission *shall deny* such registration" (emphasis added)).

comply with these requirements, we do not reach the issue of whether Dagong at this time has sufficient connection with U.S. interstate commerce to register as an NRSRO and invoke our regulatory and oversight authority.¹⁸

Accordingly, IT IS ORDERED that the application for registration as a Nationally Recognized Statistical Rating Organization filed by Dagong Global Credit Rating Co., Ltd., on December 24, 2009 be, and it hereby is, DENIED.

By the Commission.

Elizabeth M. Murphy
Secretary

¹⁸ On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 ("Dodd-Frank Act"). In Subtitle C of this law, Congress explained that, "[b]ecause credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial 'gatekeepers' do, the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers." To address this need, the law establishes an Office of Credit Ratings within the Commission and requires us to annually examine each NRSRO. The law also imposes new requirements on NRSROs, such as the establishment of effective internal control structures, independent board members, and policies to manage and disclose conflicts of interest. Because we find that Dagong is unable to meet the basic NRSRO examination requirements as they existed before the Dodd-Frank Act was passed, we need not reach the issue of whether Dagong could meet the new, heightened requirements.