

SECURITIES AND EXCHANGE COMMISSION
Release No. 34-65339

September 14, 2011

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”), f/k/a 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)(B) of the Exchange Act. Kroll traditionally has operated mainly under the “subscriber-paid” business model, in which the NRSRO derives its revenue from restricting access to its ratings to paid subscribers. Kroll has informed the Commission that it intends to expand its existing NRSRO business by establishing a new “issuer-paid” rating service under which it will issue ratings paid for by the issuer, underwriter, or sponsor of the security being rated. In connection with this planned expansion, Kroll has requested a temporary and limited exemption from Rule 17g-5(c)(1) on the grounds that the restrictions imposed by Rule 17g-5(c)(1) would

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

pose a substantial constraint on the firm's ability to compete effectively with large rating agencies offering comparable ratings services. Specifically, Kroll argues that given that the fees typically associated with issuer-paid engagements tend to be relatively high when compared to the fees associated with its existing subscriber-based business, it is possible that in the early stages of its expansion the fees associated with a single issuer-paid engagement could exceed ten percent of its total net revenue for the fiscal year. Accordingly, Kroll has requested that the Commission grant it an exemption from Rule 17g-5(c)(1) for any revenues derived from non-subscription based business during the remainder of calendar years 2011 and 2012, which are also the end of Kroll's 2011 and 2012 fiscal years, respectively.

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.² The Commission has previously granted two temporary exemptions from Rule 17g-5(c)(1), including one on February 11, 2008 to LACE, as Kroll was formerly known, in connection with its initial registration as an NRSRO ("LACE Exemptive Order").³ The Commission noted several factors in granting that exemption, including the fact that the revenue in question was earned prior to the adoption of the rule, the likelihood of smaller firms such as LACE being more likely to be affected by the rule, LACE's expectation that the percentage of total revenue provided by the relevant client would decrease, and the increased competition in the asset-backed securities class that could result from LACE's registration. In granting the LACE Exemptive Order, the Commission also noted that an exemption would further the primary purpose of the Credit Rating Agency Reform Act of 2006

² Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33598 (June 18, 2007).

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

(“Rating Agency Act”) as set forth in the Report of the Senate Committee on Banking, Housing, and Urban Affairs accompanying the 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”.⁴ On June 23, 2008, the Commission, citing the same factors set forth in the LACE Exemptive Order, issued a similar order granting Realpoint LLC a temporary exemption from the requirements of Rule 17g-5(c)(1) in connection with Realpoint LLC’s registration as an NRSRO.⁵

On September 2, 2010, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings (“LACE/Putnam Order”) against LACE and Barron Putnam, LACE’s founder as well as its majority owner during the relevant time period. The LACE/Putnam Order found, among other things, that the firm made misrepresentations in its application to become registered as an NRSRO and its accompanying request for an exemption from Rule 17g-5(c)(1). Specifically, the Commission found that the firm materially misstated the amount of revenue it received from its largest customer during 2007.⁶ On November 9, 2010, the Commission issued an Order Making Findings and Imposing A Cease-and-Desist Order (the “Mouzon Order”) against LACE’s former president, Damyon Mouzon. The Mouzon Order found, among other things, that as LACE’s president, Mouzon was responsible for ensuring the accuracy of the information provided to the Commission in connection with the firm’s NRSRO application and its request for an exemption, and that he knew or should have

⁴ See 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).

⁵ Release No. 34-58001 (June 23, 2008), 73 FR 36362 (June 26, 2008).

⁶ In the Matter of LACE Financial Corp. and Barron Putnam, Respondents: Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15E(d) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders, Release No. 62834 (September 2, 2010).

known that the financial information that LACE provided to the Commission in connection with its NRSRO application and its request for an exemption from Rule 17g-5(c)(1) was inaccurate.⁷ LACE, Putnam and Mouzon each consented to the entry of those orders on a neither admit nor deny basis.

In the request that is subject to this Order, Kroll acknowledged the recent orders against LACE and its former owner and president and stated that it has taken significant steps to enhance the compliance and other functions associated with the traditional subscriber-based business, including replacing senior management, retaining new compliance and financial personnel, and adding new independent directors comprising a majority of the board. Kroll has informed Commission staff that LACE's former ownership and management personnel no longer have any ownership or other relationship, financial or otherwise, with Kroll. Kroll has further informed Commission staff that LACE ceased performing any work or analysis in connection with the issuer-paid ratings that were the subject of the LACE Exemptive Order in December 2008.

The Commission believes that a temporary, limited and conditional exemption allowing Kroll to enter the market for rating structured finance products is consistent with the Commission's goal of improving ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry. In order to maintain this exemption, Kroll will be required to publicly disclose in Exhibit 6 to Form NRSRO, as applicable, that the firm received more than 10% of its net revenue in fiscal years 2011 and 2012 from a client or clients that paid it to rate asset-backed securities. This disclosure is designed to alert users of credit ratings to the existence of this specific conflict and

⁷ In the Matter of Damyon Mouzon, Respondent: Order Making Findings and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934, Release No. 63280 (November 9, 2010).

is consistent with exemptive relief the Commission has previously granted to LACE and Realpoint LLC. Furthermore, in addition to Kroll's existing obligations as an NRSRO to maintain policies, procedures, and internal controls, by the terms of this order, Kroll will also be required to maintain policies, procedures, and internal controls specifically designed to address the conflict created by exceeding the 10% threshold. Finally, the Commission notes that Kroll is subject to the September 2, 2010 Order Instituting Administrative and Cease-and-Desist Proceedings against LACE Financial Corp.

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 part of this annual examination regimen for NRSROs, Commission staff will closely review Kroll's activities with respect to managing this conflict and meeting the conditions set forth below and will consider whether to recommend that the Commission take additional action, including administrative or other action.

The Commission therefore finds that a temporary, limited and conditional exemption allowing Kroll to enter the market for rating structured finance products 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 Kroll's making public disclosure of the conflict created by exceeding the 10% threshold and maintaining policies, procedures and internal controls to address that conflict, 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, 2013, with respect to any revenue derived from issuer-paid ratings, provided that: (1) Kroll Bond Rating Agency, Inc. publicly discloses in Exhibit 6 to Form NRSRO, as applicable, that the firm received more than 10% of its total net revenue in fiscal year 2011 or 2012 from a client or clients; and (2) in addition to fulfilling its existing obligations as an NRSRO to maintain policies, procedures, and internal controls, Kroll Bond Rating Agency, Inc. also maintains policies, procedures, and internal controls specifically designed to address the conflict created by exceeding the 10% threshold.

By the Commission.

Elizabeth M. Murphy
Secretary