

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 90037 / September 29, 2020

ADMINISTRATIVE PROCEEDING
File No. 3-20097

In the Matter of

**KROLL BOND RATING
AGENCY, LLC,**

Respondent.

**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 A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15E(d) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”), against Kroll Bond Rating Agency, LLC. (“KBRA” or “Respondent”).

II.

In anticipation of the institution of these proceedings, KBRA has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, KBRA consents to the entry of this 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 a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and KBRA’s Offer, the Commission finds that:

Summary

1. This matter concerns KBRA’s failure to establish, maintain, enforce and document policies and procedures reasonably designed to assess the probability that an issuer of

collateralized loan obligation (“CLO”) combination notes (“Combo Notes”) will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security, as required by Rule 17g-8(b)(1) of the Exchange Act.

2. From at least November 2018, KBRA failed to establish, maintain, enforce and document the required policies and procedures. As a consequence, KBRA issued and maintained ratings of CLO Combo Notes that departed from the objectives set forth in Rule 17g-8(b)(1).

3. Specifically, KBRA assigned ratings to CLO Combo Notes that were limited to the repayment of a defined “Rated Balance” amount. KBRA’s ratings of CLO Combo Notes did not include cash flows payable to CLO Combo noteholders beyond the Rated Balance amount, even though noteholders were entitled to these payments under the terms of the security. The Rated Balance was not the entire promise to noteholders under the terms of the security.

Respondent

4. KBRA is a Delaware limited liability company, headquartered in New York, New York and has been registered as a Nationally Recognized Statistical Rating Organization (“NRSRO”) since 2008.

Facts

KBRA Rated CLO Combo Notes to a “Rated Balance” that is Different from the Payout to Investors

5. Since November 2018, upon engagement by certain entities, KBRA has issued credit ratings for CLO Combo Notes, which are a type of re-securitization of CLOs. CLOs are structured finance vehicles typically backed by portfolios of corporate loans and are usually structured by the issuer or sponsor as a series of tranches of interest-paying securities, along with a tranche of unrated equity. CLO Combo Notes can combine some or all of the unrated equity with one or more rated debt tranches of a given CLO into a pass-through security without additional credit enhancement. The ultimate cash flows payable to a holder of a CLO Combo Note are the same as the cash flows payable to a holder of the corresponding portions of the underlying component CLO tranches. The risk of non-payment of the promised cash flows to the holder of the CLO Combo Note is also the same as the risk of non-payment of the ultimate return to a holder of the corresponding portions of the underlying component CLO tranches.

6. In a 2019 publication, KBRA described that a Combo Note’s “main purpose” was to “improve overall capital efficiency” and noted that the “blending of notes and equity prevents the combo notes from incurring large losses, while providing an enhanced yield.”

7. The CLO Combo Notes rated by KBRA included a defined Rated Balance amount and directed that noteholders were entitled to receive cash flows from the underlying components of the CLO Combo Note after the Rated Balance was reduced to zero. KBRA’s ratings of CLO Combo Notes were limited to repayment of the Rated Balance amount of each CLO Combo Note and did not reflect the risk associated with any cash flows payable to holders of the CLO Combo Note over and above the Rated Balance, even though such amounts could materialize, and would be payable to the holders of the CLO Combo Note.

8. During the relevant period, KBRA used its Global Structured Credit Global Rating Methodology (“Methodology”) to rate CLO Combo Notes. KBRA’s Methodology “was developed with the goal of producing credit ratings that perform in accordance with KBRA’s published rating definitions.” For ratings of CLO Combo Notes, CLO tranches, and other structured finance vehicles, KBRA defines its ratings using a “long-term credit” rating scale. KBRA’s long-term credit rating scales states that its ratings “are intended to reflect both the probability of default and severity of loss in the event of default, with greater emphasis on probability of default at higher rating categories.” Each of the CLO Combo Notes rated by KBRA was assigned ratings of “BBB-” or higher. KBRA defines a rating of “BBB-” to mean that the security is “determined to be of medium quality with some risk of loss due to credit-related events. Such issuers and obligations may experience credit losses during stress environments.” For long-term credit, not including declarations of bankruptcy or distressed asset sales, KBRA defines default as occurring if “there is a missed interest payment, principal payment, or preferred dividend payment, as applicable, on a rated obligation which is unlikely to be recovered.”

9. KBRA’s Methodology allowed KBRA to rate only the Rated Balance of a CLO Combo Note. During the relevant period, KBRA’s Methodology stated that “transactions may issue combination notes, which are generally comprised of two or more tranches of a transaction’s issued securities and/or equity.” For transactions in which the payments from the underlying components are used to reduce the outstanding balance of the CLO Combo Note, KBRA’s Methodology stated that “such obligations may carry a rating from KBRA that only addresses the repayment of principal.” The Methodology thus allowed KBRA to, under some circumstances, rate only the likelihood of the repayment of the notional amount of a CLO Combo Note, even though the CLO Combo Notes KBRA rated entitled noteholders to receive cash flows of the underlying components after the Rated Balance was reduced to zero. The KBRA rating did not reflect the risk associated with cash flows payable to noteholders over and above the Rated Balance, even though such amounts could materialize as the components continued to perform, and would be payable to the noteholders.

10. Consequently, KBRA’s CLO Combo Note ratings addressed only the Rated Balance amount set by the issuer in the CLO Combo Note’s transaction documents. The Rated Balance did not reflect the actual promise to noteholders. By limiting KBRA’s rating to the Rated Balance, and not including cash flows payable beyond that amount, KBRA’s CLO Combo Note ratings did not assess the probability that the issuers will default, fail to make timely payments, or otherwise not make payments in accordance with the terms of the security.

Use of KBRA’s Combo Note Ratings

11. Some of the CLO Combo Notes rated by KBRA have been purchased by life insurance companies, which are regulated by state insurance commissioners. The National Association of Insurance Commissioners (“NAIC”) is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. The NAIC’s Securities Valuation Office (“SVO”), is responsible for the day-to-day credit quality assessment of securities owned by state-regulated insurance companies. The SVO regulates the investments owned by insurance companies by requiring insurance companies to reserve an amount of capital based on the perceived credit risk of its investments, also known as risk-based capital (“RBC”) reserves. Generally, investments

with lower risk require a lower RBC, which is calculated as a percentage of the amount invested; higher risk investments require a higher percentage of RBC. Under NAIC guidelines, a Combo Note rated BBB- by KBRA would incur a 1.3% risk-based capital charge. By contrast, investing directly in the unrated equity component of that same Combo Note would require a life insurance company to reserve 30% of the investment as a risk-based capital charge.

12. Life insurance companies that invested in KBRA-rated CLO Combo Notes were able to use the investment-grade ratings assigned by KBRA to compute RBC charges. KBRA was generally aware that insurance companies sometimes purchased the CLO Combo Notes rated by KBRA and that its rating letters may be provided to the NAIC.

KBRA's Policies and Procedures

13. During the relevant time period, KBRA's rating scales stated that "KBRA's ratings are intended to reflect both the probability of default and severity of loss in the event of default." Default, in turn, is defined as "a missed interest payment, principal payment, or preferred dividend payment, as applicable, on a rated obligation which is unlikely to be recovered." These definitions also appear in Exhibit 1 to KBRA's Form NRSRO, filed with the Commission.

14. KBRA failed to establish, maintain, enforce and document internal policies and procedures that were reasonably designed to assess the probability that an issuer of CLO Combo Notes will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security because KBRA's policies and procedures were not reasonably designed to ensure that KBRA's analysts rate all payments promised to holders of a CLO Combo Note as set forth in the transaction documents. KBRA had no other policies or procedures that addressed this requirement.

Violation

15. Section 938 of the Dodd-Frank Act, entitled "Universal Ratings Symbols," provides that the Commission shall require, by rule, each NRSRO to establish, maintain, and enforce written policies and procedures that, in relevant part, "(1) assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument." See Dodd-Frank Act, Pub. L. No. 111-203, 938(a)(1) (2010).

16. The Commission implemented Section 938(a) by adopting Rule 17g-8(b) of the Exchange Act. Rule 17g-8(b)(1) provides, in relevant part: "A[n NRSRO] must establish, maintain, enforce, and document policies and procedures that are reasonably designed to: (1) Assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument."

17. As a result of the conduct described above, KBRA willfully¹violated Rule 17g-8(b)(1) of the Exchange Act.

IV.

Undertakings

Respondent has undertaken to do the following within 180 days of the entry of this Order:

A. KBRA shall complete a comprehensive review of its policies, procedures, and internal controls that relate to the findings in this Order, including to assess compliance with Rule 17g-8(b)(1).

B. KBRA shall submit a report summarizing actions taken to comply with the undertaking, and describing the revised or new policies and procedures established and documented under Rule 17g-8(b)(1), and the actions taken to maintain and enforce the revised or new policies and procedures as required by the rule. The report shall be supported by exhibits sufficient to demonstrate compliance, including but not limited to KBRA's revised or newly established policies and procedures, and any revisions made to existing ratings. The Staff may make reasonable requests for further evidence of compliance and KBRA agrees to provide such evidence. The report and supporting material shall be submitted no later than 180 days from the date of this Order to Jeffrey P. Weiss, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549. Respondent agrees that if the Division of Enforcement believes that Respondent has not satisfied these undertakings, it may petition the Commission to reopen the matter to determine whether additional sanctions are appropriate.

C. Certify, in writing, compliance with the undertaking(s) set forth above. The certification shall identify the undertaking(s), provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and KBRA agrees to provide such evidence. The certification and supporting material shall be submitted to Jeffrey P. Weiss, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

D. Deadlines for procedural dates shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday, the next business day shall be considered to be the

¹ "Willfully," for purposes of imposing relief under Section 15E(d) of the Exchange Act, "means no more than that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). The decision in *The Robare Group, Ltd. v. SEC*, which construed the term "willfully" for purposes of a differently structured statutory provision, does not alter that standard. 922 F.3d 468, 478-79 (D.C. Cir. 2019) (setting forth the showing required to establish that a person has "willfully omit[ted]" material information from a required disclosure in violation of Section 207 of the Advisers Act).

last day. For good cause shown, the Staff may extend any of the procedural dates relating to the undertakings.

V.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent KBRA's Offer.

Accordingly, pursuant to Sections 15E(d) and 21C of the Exchange Act, it is hereby ORDERED that:

A. KBRA cease and desist from committing or causing any violations and any future violations of Rule 17g-8(b)(1) of the Exchange Act;

B. KBRA is hereby censured;

C. KBRA shall pay disgorgement of \$160,000.00, prejudgment interest of \$4,836.33 and civil penalties of \$600,000.00, to the Securities and Exchange Commission. Payment shall be made in the following installments: KBRA shall pay \$60,000.00 of the disgorgement amount and all prejudgment interest within thirty (30) days of the entry of this Order. KBRA shall pay the remaining \$100,000.00 of disgorgement within 364 days of the entry of this Order. KBRA shall pay \$130,000.00 of the civil penalty within thirty (30) days of the entry of this Order. KBRA shall pay the remaining \$470,000.00 of the civil penalty amount within 364 days of the entry of this Order. Payments shall be applied first to post-order interest, which accrues pursuant to SEC Rule of Practice 600 and/or pursuant to 31 U.S.C. §3717. Prior to making the final payment set forth herein, Respondent shall contact the staff of the Commission for the amount due. If Respondent fails to make any payment by the date agreed and/or in the amount agreed according to the schedule set forth above, all outstanding payments under this Order, including post-order interest, minus any payments made, shall become due and payable immediately at the discretion of the staff of the Commission without further application to the Commission.

Payments must be made in one of the following ways:

- (1) KBRA may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) KBRA may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) KBRA may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying KBRA as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Jeffrey P. Weiss, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

D. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, a Fair Fund is created for the disgorgement, prejudgment interest and penalties referenced in paragraph C above. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that in any Related Investor Action, it shall not argue that it is entitled to, nor shall it benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that it shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

E. KBRA shall comply with the undertakings enumerated in Section IV above.

By the Commission.

Vanessa A. Countryman
Secretary