Morningstar Credit Ratings, LLC Position Paper
SEC v. Morningstar Credit Ratings, LLC

Feb. 17, 2021

Independent credit ratings are vital to the U.S. capital markets and are protected under federal law. Despite this fundamental principle, the Securities and Exchange Commission has filed a complaint against Morningstar's former credit rating agency, Morningstar Credit Ratings, LLC (MCR), that in the guise of a complaint about MCR's disclosures and internal controls, seeks to infringe on the analytical independence of credit rating agencies and to overreach the SEC's regulatory authority. MCR is litigating this case with the SEC to vindicate the analytical independence of all credit rating agencies, the integrity of its own credit ratings and ratings methodologies, and its compliance with the relevant rules and regulations. MCR believes a federal court decision in this case will clarify the regulatory framework applicable to the entire credit ratings industry.

The SEC's case against MCR relates to a legacy credit rating methodology that MCR used to rate commercial mortgage-backed securities, or CMBS, between 2015 and 2017. The SEC's principal allegation relates to forms MCR filed with the SEC, but the SEC's real objection is that MCR's legacy methodology gave its analysts discretion to make adjustments to some default settings based on their analytical judgment and experience. The SEC's position violates the statutory protection afforded to the substance of credit rating methodologies. The SEC's position is also contrary to the relevant SEC rules and the SEC's authoritative policy statements. The SEC's case is an attempt to implement impermissible regulation by enforcement.

The SEC's Enforcement Action Violates the Legally Protected Independence of Credit Ratings

Under the federal securities laws, credit rating agencies provide opinions on the creditworthiness of securities such as CMBS. It is vital to investors and the capital markets that credit ratings represent an independent assessment of credit risk. For that reason, the Credit Rating Agency Reform Act of 2006 prohibits the SEC from regulating the substance of credit ratings or the procedures and methodologies used to determine credit ratings.[1] This statutory limitation protects the analytical independence of credit rating agencies. While the SEC can regulate credit rating agencies, it may never regulate the substance of credit ratings or credit rating methodologies.

Analytical independence is important across Morningstar, including Morningstar's credit rating business. Morningstar's brand strength comes from its reputation for independence and integrity. Morningstar's decades-long culture and safeguards enable it to stand behind all of its research and ratings, and Morningstar will continue to bring clarity and diverse opinions to the market.

1 *See* Securities and Exchange Act of 1934, Section 15E(c)(2), 15 U.S.C. §78o–7(c)(2) (codifying Credit Rating Agency Reform Act of 2006).

Morningstar recognizes the diversity of opinion that comes from incorporating analysts' experience and judgment into its analytical approach. Credit rating agencies consider appropriate qualitative factors reflecting highly idiosyncratic commercial property features and credit risks that may not be fully reflected in a purely quantitative analysis. Intangibles can matter. It may not be possible or appropriate to compile in advance an exhaustive list of every single fact or circumstance that might be relevant to credit analysis—and even if it were, it is not possible to specify in advance of a particular analytical review how they should be applied. Anyone who understands credit rating agencies understands that.

MCR used qualitative components that explicitly permitted qualitative analysis by its analytical personnel based on their experience and judgment. MCR's overall assessment of creditworthiness depended in part on such qualitative factors.

In this case, MCR's legacy CMBS credit rating methodology incorporated two qualitative factors among numerous other quantitative inputs in its rating model. MCR's CMBS credit ratings included a qualitative assessment of how assets could be expected to perform in a variety of stress scenarios. The SEC is now questioning MCR's use of those qualitative assessments. According to the SEC, MCR should have had established quantitative parameters or other criteria for the qualitative factors that were part of its legacy CMBS ratings model. In this way, the SEC is attempting to dictate the substance of MCR's rating methodology—which it is expressly prohibited from doing by statute.

MCR is litigating this case against the SEC to vindicate the statutory limitations on the SEC's power to regulate the substance of credit rating methodologies. MCR expects the analytical independence of all credit rating agencies will be upheld and the limits on the SEC's regulatory authority will be clarified. The entire credit rating industry will benefit from judicial precedent enforcing this important legal principle.

Integrity of MCR's Credit Ratings Remains Intact

At all times when MCR operated as a credit rating agency, the integrity of its credit ratings was paramount. MCR exercised its analytical judgement appropriately, and applied the credit rating methodology that was documented in its books and records and appropriately disclosed consistent with SEC rules. The SEC's complaint insinuates that there was something wrong with MCR's credit ratings without any evidence, but its actual claims and allegations never call into question the integrity of previous MCR credit ratings.

No Investor Harm

Despite vague insinuations in its complaint, the SEC has not alleged any harm to investors from MCR's use of its legacy methodology. The legacy methodology at issue in this case was last used to determine a CMBS credit rating in March 2017—nearly four years ago. No credit ratings that were determined using the legacy methodology remain outstanding.

The SEC's Position Violates Due Process With Impermissible Regulation by Enforcement

Credit rating agencies are heavily regulated and routinely examined by the SEC. Leaving aside the other infirmities of the SEC's case against MCR, the SEC is attempting to improperly impose new disclosure and substantive regulatory requirements governing quantitative models of credit rating agencies that ignore existing law and the fundamental way credit rating agencies determine credit ratings. The federal securities laws require new regulations to be created through notice-and-comment rulemaking—not an enforcement action.[2] The SEC's case against MCR amounts to improper regulation by enforcement.

The SEC is attempting to impose a novel and unprecedented regulatory standard on MCR. SEC regulations require credit ratings agencies to provide only a "general description of the procedures and methodologies" used in the ratings process—not their entire model or every detail of their methodology. MCR complied with this rule by providing a detailed description of its methodology, far exceeding the required general description. Now the SEC is attempting for the first time to mandate more than its own rules require, by claiming MCR should have disclosed specific inputs to its model. The SEC's purported standard deprives credit rating agencies of fair notice about what the SEC requires, making arbitrary enforcement inevitable—exactly what has happened here. In fact, the SEC did not even follow its regular practices in making its allegations against MCR. As the Supreme Court has held, SEC rules that "regulate persons or entities must give fair notice of conduct that is forbidden or required."[3] The SEC's new regulatory standard, at best, is based on a strained reading of the rule, which courts have held violates due process.[4] If the SEC believes additional rules are required—consistent with the analytical independence of a credit rating agency—the agency should go through the rulemaking process, not file an action against MCR.

MCR Cooperated With the SEC's Investigation

The SEC's litigated enforcement action is the final chapter in an investigation that started almost five years ago with a voluntary request for information sent to MCR in February 2016. Since that time, MCR has cooperated fully with the SEC staff's investigation, on a voluntary basis, responding to numerous requests and producing MCR employees to testify. While MCR would prefer to avoid litigation with the SEC, the SEC has unfortunately taken unreasonable and unlawful positions here that have left MCR with no choice but to contest this matter in court.

The SEC's Case Does Not Relate to Morningstar's Current Credit Rating Business

MCR is the former credit rating business of Morningstar, Inc. In July 2019, Morningstar acquired DBRS, another credit rating agency, and it integrated the operations of MCR and DBRS, Inc. under the name "DBRS Morningstar." MCR withdrew its registration with the SEC in December 2019. It no longer operates as a credit rating agency, and all of its outstanding credit ratings were withdrawn in October 2020. The SEC's enforcement action relates solely to legacy MCR—prior to the acquisition of DBRS—and has nothing to do with the current DBRS Morningstar credit rating business.

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2 *See* Exchange Act Section 17(a)(1), 15 U.S.C. § 15q(a)(1).

3 FCC v. Fox Television Stations, Inc., 567 U.S. 239, 253 (2012).

4 *See KPMG, LLP v. SEC*, 289 F.3d 109, 116 (D.C. Cir. 2002).

MCR believes the outcome of this litigation, even if the matter is decided adversely to it, should have, at most, a de minimis financial outcome. Morningstar does not believe the outcome of this litigation will have any material effect on it or its current credit rating business.

Morningstar's well-known independent investment research and ratings are separate from and unrelated to the credit rating business. The SEC case has nothing to do with Morningstar's investment research.

Next Steps

MCR intends to vigorously defend itself and will respond appropriately in federal court.