**INFORMATION MEMORANDUM**
**April 6, 2009**

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| **TO:** | **The Commission** | |
| **FROM:** | **The Office of Compliance Inspections and Examinations** | |
| **SUBJECT:** | **Credit Rating Agencies: Remedial Measures Taken To Date Following the Staff's 2008 Examinations** | |
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## I. Summary

The purpose of this memorandum is to update the Commission on the status of remedial measures taken by three nationally recognized statistical rating organizations -- Fitch Ratings, Ltd. ("*Fitch*"), Moody's Investor Services, Inc. ("*Moody's*") and Standard & Poor's Ratings Services ("*S&P*") -- in response to the Staff's 2008 examinations of those firms. Overall, the Staff believes these credit rating agencies made numerous significant improvements in response to our recommendations; however, some of the steps that the firms agreed to take in response to the examinations have not yet been implemented. In addition, two of the rating agencies did not implement the Staff's recommendation to undertake a "broad review of their practices, policies and procedures to further mitigate and manage the issuer-pays conflict of interest.… [including] steps that would insulate or prevent the possibility that considerations of market share and other business interests

could influence ratings or ratings criteria," and the third failed to fully implement corrective measures.
The examination findings, the recommendation made to each firm, and the general status of the implementation of remedial actions are summarized below (and described in greater detail for each firm examined in Section III of this memorandum).

**Finding:** There was a substantial increase in the number and in the complexity of RMBS and CDO deals since 2002, and some of the rating agencies appear to have struggled with the growth.

*Recommendation*: The Staff recommended that all three firms evaluate, both at that time and on a periodic basis, whether they have sufficient staff and resources to manage their volume of business and meet their obligations under the Securities Exchange Act of 1934 ("Exchange Act").

*Status*: *Moody's* implemented the recommendation. *Fitch* expects to implement the recommendation by June 30, 2009 and *S&P* expects to fully implement the recommendation in 2010.

**Finding:** Significant aspects of the ratings process were not always disclosed.

*Recommendation*: The Staff recommended that all three firms conduct a review of their current disclosures of their processes and methodologies for rating RMBS and CDOs to assess whether they are fully disclosing their ratings methodologies and meeting the requirements of the Exchange Act. Further, the Staff recommended that all three firms review whether their policies governing the timing of disclosure of a significant change to a process or methodology are reasonably designed to comply with these requirements.

*Status*: *Moody's* implemented the recommendation. *Fitch* expects to complete implementation of the recommendation by September 30, 2009 and *S&P* expects to complete implementation by the end of 2009.

**Finding**: Policies and procedures for rating RMBS and CDOs can be better documented, as the examined rating agencies did not have specific written procedures for rating RMBS and CDOs and did not appear to have specific policies and procedures to identify or address errors in their models or methodologies.

*Recommendation:* The Staff recommended that all three firms conduct a review to determine whether their written policies and procedures used to determine credit ratings for RMBS and CDOs are fully documented in accordance with the requirements of the Exchange Act.

*Status: S&P* disagreed in part with the Staff's recommendation and stated in its response that its policies are "principles-based" and can be "adapted to numerous individual deal scenarios." Nonetheless, *S&P* conducted a review and implemented new policies and procedures. *Moody's* implemented the recommendation, and *Fitch* expects to complete implementation by September 30, 2009.

*Recommendation:* The Staff recommended that *Fitch* and *S&P* review their procedures to identify, correct and rectify errors in its ratings models and methodologies. The Staff recommended that *Moody's* develop policies and procedures to address the detection of errors with its models, methodologies, or other aspects of the ratings process. The Staff also recommended that *Moody's* develop policies and procedures for the reporting and correction of discovered errors in its models, methodologies, or other aspects of the ratings process.

*Status: Moody's* implemented the recommendation. *Fitch* expects to implement the recommendation by September 30, 2009 and *S&P* expects to fully implement the recommendation by the end of 2009.

**Finding:** The rating agencies did not always document significant steps in the ratings process -- including the rationale for deviations from their models and for rating committee actions and decisions -- and they did not always document significant participants in the ratings process.

*Recommendation*: The Staff generally recommended that all three firms conduct a review of their current policies and practices for documenting the credit rating process. This review should have identified whether the current policies are reasonably designed to ensure compliance with the Exchange Act, and addressed weaknesses in the policies or in adherence to existing policies that result in gaps in documentation of significant steps in the credit rating process.

*Status: Moody's* implemented the recommendation. *Fitch* and *S&P* expect to complete implementation by June 30, 2009.

**Finding**: The surveillance processes used by the rating agencies appear to have been less robust than their initial ratings processes.

*Recommendation:* The Staff recommended that all three firms conduct a review to determine if adequate resources are devoted to surveillance of outstanding RMBS and CDO ratings. The Staff also recommended that all three firms develop comprehensive written surveillance policies and procedures. In addition, the Staff recommended that *Fitch* and *S&P* ensure that all appropriate surveillance records are retained.

*Status: Moody's* implemented the recommendation. *Fitch* expects to complete implementation by September 30, 2009, and *S&P* expects to complete implementation by the end of 2009.

**Finding**: Issues were identified in the management of conflicts of interest and improvements can be made. Specifically, analysts appeared to be aware, when rating an issuer, of the rating agency's business interest in securing the rating of the deal. Rating agencies did not appear to take steps to prevent considerations of market share and other business interests from the possibility that they could influence ratings or ratings criteria.

*Recommendation:* The Staff recommended that all three firms conduct a broad review of their practices, policies and procedures to further mitigate and manage the issuer-pays conflict of interest. In particular, the Staff recommended that all three firms consider steps that would insulate or prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria.

*Status: Fitch* did not conduct a broad review of how it manages the issuer-pays conflict (it only implemented new policies that separate analysts from fee discussions). *Moody's* also did not conduct a broad review of how it manages the issuer-pays conflict (it only implemented new policies for compliance monitoring). *S&P* conducted a broad review, and expects to implement new policies by the end of 2009; however, these policies do not fully address the conflicts identified by the Staff in its examination.

**Finding:** The rating agencies varied in how rigorously they monitor or prevent prohibited securities transactions, including personal trading by their employees.

*Recommendation:* The Staff recommended that all three firms conduct a review of their policies and procedures for managing the securities ownership conflict of interest to determine whether they are reasonably designed to ensure that their employees' personal trading is appropriate and does not violate the Exchange Act.

*Status*: *Fitch* implemented the recommendation. *Moody's* expects to complete implementation of the recommendation by April 30, 2009 and *S&P* expects to complete implementation by June 30, 2009.

**Finding:** The rating agencies' internal audit processes varied significantly.

*Recommendation*: The Staff recommended that *Fitch* continue to conduct internal audits and periodically review whether improvements are warranted to its audit program. The Staff recommended that *Moody's* and *S&P* review whether their internal audit functions, particularly in the RMBS and CDO ratings areas, are adequate, and whether it provides for proper management follow-up.

*Status*: *Fitch, Moody's* and *S&P* implemented the recommendation.

The Staff intends to provide follow-up letters to each examined firm reinforcing the need for prompt action to implement the remedial actions, and reiterating certain recommendations related to conflicts of interest and ratings procedures, as applicable, based on the firms' inadequate responses.

## II. Background

In August 2007, the Staff in the Office of Compliance Inspections and Examinations, Division of Trading and Markets and the Office of Economic Analysis initiated examinations *Fitch, Moody's* and *S&P* to review their role in the recent turmoil in the subprime mortgage-related securities markets. The focus of the examinations was the rating agencies' activities in rating subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") linked to subprime residential mortgage-backed securities. Key areas of review included:

- the firms' ratings policies, procedures and practices, including gaining an understanding of ratings models, methodologies, assumptions, criteria and protocols;

- the adequacy of the disclosure of the ratings process and methodologies used by the firms;

- whether the firms complied with their ratings policies and procedures for initial ratings and ongoing surveillance;

- the efficacy of the firms' conflict of interest procedures; and

- whether ratings were unduly influenced by conflicts of interest related to the firms' role in bringing issues to market and the compensation they receive from issuers and underwriters.

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 process, and other relevant rating agency staff. In addition, the Staff reviewed a large quantity of the rating agencies' internal records, including written policies, procedures and other such documents related to initial ratings, the ongoing surveillance of ratings, the management of conflicts of interest, and the public disclosures of the procedures and methodologies for determining credit ratings. The Staff also reviewed deal files for subprime RMBS and CDO ratings, internal audit reports and records and other internal records, including a large quantity of email communications (the rating agencies produced over two million emails and instant messages that were sorted, analyzed and reviewed using software filtering tools). Finally, the Staff reviewed the rating agencies' public disclosures, filings with the Commission and other public documents.

The examination review period generally covered January 2004 through July 2008. The firms under examination became subject to regulation as NRSROs when they registered with the Commission as NRSROs in September 2007. Although these rating agencies were not subject to legal obligations applicable to NRSROs during most of the review period, the Staff nonetheless sought to make relevant factual findings, observations and recommendations with respect to the activities of these firms in rating subprime RMBS and CDOs during the period, as well as to identify possible areas for improvement in their practices.

In July 2008, the Staff issued deficiency letters to each of the firms examined outlining findings and recommendations from the examinations.[1] The Staff also presented the examination findings and recommendations to each firm's Board of Directors in September and October 2008 and urged proactive and immediate action. The Staff requested that each firm provide a written response within 30 days of the deficiency letters outlining any remedial actions planned or taken to address the examination findings and recommendations, and also requested that each firm submit written confirmation within six months detailing the status of implementation of each remedial action.

## III. Summary of Recommendations and Remedial Measures Taken by Each Rating Agency in Response to the Staff's Recommendations

### A. Finding: There was a substantial increase in the number and in the complexity of RMBS and CDO deals since 2002, and some of the rating agencies appear to have struggled with the growth.

***Recommendation: The Staff recommended that all three firms evaluate at that time and on a periodic basis whether they have sufficient staff and resources to manage their volume of business and meet their obligations under the Exchange Act.***

#### 1. Fitch

In response to the Staff's recommendation, *Fitch* reviewed and modified its procedures for periodic review and assessment of staffing levels utilizing various formulas to determine staffing needs. *Fitch* is now in the process of conducting a firm-wide internal staffing and resource analysis under these new procedures, which it anticipates will be completed by June 30, 2009.

*The Staff is concerned about the timeliness of Fitch's remedial action, as full implementation is not expected until June 30, 2009.*

#### 2. S&P

In response to the Staff's recommendation, *S&P* implemented a resource planning model in its U.S. Structured Finance group, which uses factors such as the number of current employees, anticipated deal volume, and hours required for each endeavor, to derive a

[1] On July 8, 2008, the Commission authorized the Staff to make public a summary report of the examinations (http://www.sec.gov/news/studies/2008/craexamination070808.pdf)

baseline indicator for the adequacy of staffing levels in new ratings and surveillance. Based on the model, the U.S. Structured Finance group redeployed seven new ratings analysts to RMBS surveillance. *S&P* is also developing a similar resource planning model in corporate and government ratings at the firm, and plans to implement it firm-wide in by June 30, 2009. *S&P* will use the model periodically to inform its ongoing staffing needs.

*S&P* has also recently reorganized its U.S. Structured Finance group and cross-trains analysts in both initial ratings and surveillance so that it can better allocate resources to meet staffing needs. In addition, *S&P* is developing an analytical training, education and certification program. *S&P* expects to fully implement the program by 2010.

*The Staff is concerned about the timeliness of S&P's remedial action, as full implementation is not expected until 2010.*

### 3. Moody's

In response to the Staff's recommendation, *Moody's* conducted a firm-wide review of the adequacy of its staffing resources. The review was conducted for each business line, and considered, among other things, transaction volume, staff turnover and the overall quality of the analytical team. As a result of the staffing review, *Moody's* reallocated twenty-seven ratings analysts from initial ratings to surveillance in its Structured Finance group. *Moody's* stated that going forward this review will be conducted on an annual basis and that it will integrate the results of the review into *Moody's* existing process for reviewing staffing levels.

## B. Finding: Significant aspects of the ratings process were not always disclosed.

***Recommendation: The Staff recommended that all three firms conduct a review of their current disclosures of their processes and methodologies for rating RMBS and CDOs to assess whether they are fully disclosing their ratings methodologies and meeting the requirements of the Exchange Act. Further, the Staff recommended that all three firms review whether their policies governing the timing of disclosure of a significant change to a process or methodology are reasonably designed to comply with these requirements.***

### 1. Fitch

In response to the Staff's recommendations, *Fitch* conducted a review of policies and procedures, including for rating RMBS and CDOs, to determine if such policies and procedures fully and properly document the basis for rating decisions (both new and ongoing), including the use of models in those decisions, and whether the policies and procedures ensure the timely and complete disclosure of material changes to methodology and criteria. *Fitch* found that certain policies for RMBS and CDO ratings were not disclosed or followed in the rating process. *Fitch* is implementing new policies and procedures which it anticipates will be completed by September 30, 2009.

*The Staff is concerned about the timeliness of Fitch's remedial action, as full implementation is not expected until September 30, 2009.*

**2. S&P**

In response to the Staff's recommendation, *S&P* conducted a review and implemented several initiatives to improve disclosure of its U.S. RMBS and CDO ratings process and methodologies. First, *S&P* launched a review of the process by which it maintains, reviews and publishes criteria to ensure that its criteria is up-to-date, transparent and public. This review will be completed by June 30, 2009 and implementation is targeted for completion by the end of 2009.

*S&P* is also contemporaneously implementing three broad changes to disclosure of its policies and procedures. First, *S&P* indicated that it is redesigning its website, at a cost of approximately $5 million. In addition, *S&P* implemented new initiatives around the timing of disclosure of significant changes to rating processes and criteria in November 2008. In relevant part, the new guidelines require publication of criteria changes on *S&P* web sites and also by press release, bulletin or similar means, unless such publication would divulge "trade secrets." The new guidelines also provide that new or revised criteria may become effective immediately when announced or after a delay period of up to 45 days. Finally, *S&P* developed and implemented policies and procedures for the publication of *S&P* ratings models.

*The Staff is concerned about the timeliness of S&P's remedial action, as full implementation is not expected until the end of 2009.*

**3. Moody's**

In response to the Staff's recommendations, *Moody's* conducted a review and implemented two initiatives to improve disclosure. First, *Moody's* consolidated several methodologies for rating RMBS and CDOs into a single master methodology for each broad asset class, which will be updated annually with any incremental changes. *Moody's* will also issue quarterly press releases that identify incremental changes to procedures and methodologies in the Structured Finance group that have not been previously published.

**C. Finding: Policies and procedures for rating RMBS and CDOs can be better documented.**

- **None of the rating agencies examined had specific written procedures for rating RMBS and CDOs.**

  ***Recommendation: The Staff recommended that all three firms conduct a review to determine whether their written policies and procedures used to determine***

***credit ratings for RMBS and CDOs are fully documented in accordance with the requirements of the Exchange Act.***

### 1. Fitch

In response to the Staff's recommendation, *Fitch* conducted a firm-wide review to determine whether its written policies and procedures used to determine credit ratings are fully documented. *Fitch* identified several areas for improvement. For instance it identified the need for development of more explicit written procedures to supplement situations not covered by the current procedures, such as how to address and document exceptions to the model or criteria overrides. *Fitch* is implementing new policies and procedures which it anticipates will be completed by September 30, 2009.

*The Staff is concerned about the timeliness of Fitch's remedial action, as implementation is not expected until September 30, 2009.*

### 2. S&P

*S&P* disagreed in part with the Staff's recommendation. Specifically, in its response, *S&P* noted that its policies are "principles-based" and can be "adapted to numerous individual deal scenarios." *S&P* argues that it does not believe it "can or should prescribe fixed analytical steps that analysts should undertake for all structures that *S&P* might rate." In response to the Staff's recommendation, however, *S&P* conducted a review to determine whether its written procedures and methodologies used to determine global RMBS and CDO credit ratings are fully documented. As a result, *S&P* consolidated the procedures used by RMBS and CDO analysts, which now include step-by-step procedures for rating RMBS.

*The Staff is concerned with S&P's assertions regarding the prescription of "fixed analytical steps...for all structures S&P might rate." In its review, the Staff found that the ratings process for RMBS was fairly uniform and could be better documented. Firms are obligated to develop a record documenting the established procedures and methodologies used by the firm to determine credit ratings. This would likely include routine analytical steps used to determine a credit rating, particularly for those structures that are generally rated in a uniform manner.*

### 3. Moody's

In response to the Staff's recommendation, *Moody's* conducted a review to determine whether its procedures and methodologies used to determine credit ratings are fully documented. As a result of the review, *Moody's* drafted guidelines that set forth the general steps that an analyst takes from the time the rating process is initiated to the time a final rating is published.

- **Rating agencies do not appear to have specific policies and procedures to identify or address errors in their models or methodologies.**

***Recommendation: The Staff recommended that Fitch and S&P review their procedures to identify, correct and rectify errors in its ratings models and methodologies. The Staff recommended that Moody's develop policies and procedures to address the detection of errors with its models, methodologies, or other aspects of the ratings process. The Staff also recommended that Moody's develop policies and procedures for the reporting and correction of discovered errors in its models, methodologies, or other aspects of the ratings process.***

**1. Fitch**

In response to the Staff's recommendations, *Fitch* conducted a review of its procedures to identify, correct and disclose errors in its ratings models and methodologies, and created policies and procedures to detect and rectify such errors. The new procedures include guidance on how to identify, address, and report various types of model errors in the rating process. Fitch expects to implement these procedures by September 30, 2009.

*The Staff is concerned about the timeliness of Fitch's remedial actions, as full implementation is not expected until September 30, 2009.*

**2. S&P**

In response to the Staff's recommendations, *S&P* completed a firm-wide review of its procedures for addressing and correcting errors in its ratings models and methodologies and created policies and procedures to detect, rectify and publish errors. That process resulted in the adoption in November 2008 of error correction guidelines that require, among other things, that new rating committees be convened for material errors that are discovered, and provide procedures for documenting the error, notifying the rated entity of the error, and publishing revised rating justifications that mention the error and the attendant corrections.

In addition to establishing these procedures, *S&P* plans to conduct a review of all key ratings models currently in use. All but one of the models relating to RMBS and CDOs have been reviewed, and all *S&P* expects to review all its ratings models by the end of 2009.

Furthermore, *S&P* is developing policies and procedures related to the creation, testing and validation of its models, that will describe under what circumstances the *S&P* staff should initiate a review of ratings models, including third party models. *S&P* expects to implement any new policies or procedures by the end of 2009.

*The Staff is concerned about the timeliness of S&P's remedial actions, as full implementation is not expected until the end of 2009.*

**3. Moody's**

In its response, *Moody's* noted that prior to receipt of the Staff's deficiency letter, it began taking steps that addressed the Staff's recommendations. First, *Moody's* developed policies to be followed in the event that an error is discovered in a model that was used in the rating process.

In addition, *Moody's* began a review, prior to the Staff's deficiency letter, to verify the coding accuracy of all the primary models used in the rating process. The purpose of this review was to ensure that all of its models were programmed and functioning according to the specifications set forth in the applicable methodology. *Moody's* created a team to perform this review on an ongoing basis and stated that it intends to increase the size of this team by hiring four financial engineers.

Finally, *Moody's* began a validation review wherein it began examining the rating methodologies underlying its primary models. The validation review examines the key assumptions and overall conceptual framework of *Moody's* models to ensure that the results – even if mathematically accurate – sufficiently correspond to the real world systems that are being modeled and that the assumptions in the model are reasonable. *Moody's* created a permanent team to perform this review on an ongoing basis and expects to hire one additional staff member.

### D. Finding: Policies and procedures for rating RMBS and CDOs can be better documented.

***Recommendation: The Staff generally recommended that all three firms conduct a review of their current policies and practices for documenting the credit rating process. This review should have identified whether the current policies are reasonably designed to ensure compliance with the Exchange Act, and addressed weaknesses in the policies or in adherence to existing policies that result in gaps in documentation of significant steps in the credit rating process.***

#### 1. Fitch

In response to the Staff's recommendations, *Fitch* is currently conducting a review to ensure that appropriate ratings records are both created and maintained, and anticipates completion of the review and implementation of any new policies in this area by June 30, 2009.

*The Staff is concerned about the timeliness of Fitch's remedial actions, as full implementation is not expected until June 30, 2009.*

#### 2. S&P

*S&P* implemented changes to improve the firm-wide documentation of its ratings process. For example, *S&P* drafted new policies for the identification, retention, and disposal of all documents and records at *S&P*, as well as policies that specify the documentation required to support rating opinions. *S&P* also created new automated forms and controls that require analysts to populate certain required fields, including the identity of the analysts and committee members, as well as ratings rationales and out-of-model adjustments. *S&P* expects these forms to be fully implemented by June 30, 2009.

*The Staff is concerned about the timeliness of S&P's remedial actions, as full implementation is not expected until June 30, 2009.*

### 3. Moody's

In its response, *Moody's* noted that prior to receiving the deficiency letter it began taking steps that addressed the Staff's recommendations as part of its record retention pilot program. Some of the enhancements being tested in the record retention pilot program include implementation of an automated rating committee document, which was implemented in structured finance in July 2008. This document creates rating related information such as the identities of the committee members, vote tally, and the committee results, and is generated each time a rating committee meets. The information is uploaded into a centralized database, and *Moody's* runs daily exception reports that are reviewed by the compliance department on a weekly basis. Additionally, *Moody's* reviews randomly selected documentation on a quarterly basis to test record retention practices.

## E. Finding: The surveillance processes used by the rating agencies appear to have been less robust than their initial ratings processes.

***Recommendation: The Staff recommended that all three firms conduct a review to determine if adequate resources are devoted to surveillance of outstanding RMBS and CDO ratings. The Staff also recommended that all three firms develop comprehensive written surveillance policies and procedures. In addition, the Staff also recommended that Fitch and S&P ensure all appropriate surveillance records are retained.***

### 1. Fitch

In response to the Staff's recommendation, *Fitch* reviewed and modified its procedures for the periodic review and assessment of staffing levels utilizing various formulas to determine staffing needs. *Fitch* is now in the process of conducting a firm-wide internal staffing and resource analysis under these new procedures. This review will be completed by June 30, 2009.

*Fitch* also conducted a review to determine whether it maintains comprehensive written surveillance procedures. *Fitch* plans to implement changes to its surveillance procedures by September 30, 2009.

Finally, *Fitch* conducted a review of its policies to ensure that it provides for the maintenance and creation of surveillance documents that appropriately document the

basis for ratings decisions, including identifying the analysts who participated in the rating decision. These policies will be completed by June 30, 2009.
*The Staff is concerned about the timeliness of Fitch's remedial actions, as full implementation is not expected until September 30, 2009.*

### 2. S&P

In response to the Staff's recommendation, *S&P* conducted a review of its surveillance resources as part of its firm-wide review of staffing levels. As a result, *S&P* implemented a reorganization of staff within the U.S. Structured Finance group, redeployed seven RMBS new rating staff members to RMBS surveillance, implemented the Resource Planning Model to create baseline staffing levels, and enhanced its analytical training and certification.

*S&P* also conducted a review of its Structured Finance surveillance procedures in an effort to identify areas where it can take steps to improve the procedures, data and tools. As a result, *S&P* drafted new procedures to provide Structured Finance surveillance analysts with a description of the primary steps to be performed in conducting surveillance. With respect to U.S. RMBS, *S&P* is attempting to make transaction-level exception reporting more useful by refining the filters used to monitor performance. *S&P* also noted that it was using a new provider of monthly RMBS performance data and had improved its surveillance methodologies.

Finally, *S&P* conducted a review of its processes relating to documentation of surveillance records. As a result, it implemented procedures for surveillance document tracking. *S&P* also plans to implement an automated surveillance tracking system by the end of 2009.

*The Staff is also concerned about the timeliness of S&P's remedial action, as full implementation is not expected until the end of 2009.*

### 3. Moody's

In response to the Staff's recommendation, *Moody's* conducted a review of its surveillance resources as part of its overall firm-wide review of staffing levels. As a result of that review, *Moody's* reorganized its structured finance ratings and surveillance functions to emphasize independence. *Moody's* also reallocated twenty-seven ratings analysts from initial ratings to surveillance in the structured finance group. *Moody's* stated that going forward this review will be conducted on an annual basis and that it will integrate the results of the review into *Moody's* existing process for reviewing staffing levels. In addition, *Moody's* created a new senior management position to oversee structured finance surveillance operations worldwide.

In addition, *Moody's* prepared written surveillance procedures that provide guidance to the structured finance surveillance staff on items including: the method of review, the use of systems and tools, applicable methodologies, committee composition and record retention obligations.

**F. Finding: Issues were identified in the management of conflicts of interest and improvements can be made.**

- **Analysts appeared to be aware, when rating an issuer, of the rating agency's business interest in securing the rating of the deal. Rating agencies did not appear to take steps to prevent considerations of market share and other business interests from the possibility that they could influence ratings or ratings criteria.**

  ***Recommendation: The Staff recommended that all three firms conduct a broad review of their practices, policies and procedures to further mitigate and manage the issuer-pays conflict of interest. In particular, the Staff recommended that all three firms consider steps that would insulate or prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria.***

**1. Fitch**

In response to the Staff's recommendations, *Fitch* conducted a review of its conflicts practices, policies and procedures. As a result, it drafted new policies to complete the separation of the analytical and business development functions that now prohibit analysts at any level from discussing fees.

*While Fitch created new policies that separate the analysts from fee discussions, the Staff is concerned that it did not conduct a broad review of how it manages the issuer–pays conflict of interest.*

**2. S&P**

In response to the Staff's recommendations, *S&P* conducted a firm-wide review of its conflicts practices, policies and procedures. As a result, it began implementing several initiatives in this area. First, *S&P* plans to implement by the end of 2009, new policies and procedures that prohibit analysts from participating in recording or retaining fee information, or participating in business discussions about market share or other financial matters (as will be required under the new rules applicable to NRSROs which take effect on April 10, 2009). Furthermore, additional controls are being implemented to limit *S&P* staff with commercial responsibilities from interacting with analytical staff on analytical matters, including a requirement that communications between analytical and business staff be conducted through an intermediary to ensure adherence with conflict management policies.

In addition, *S&P* is realigning performance goals for compensation for analytical staff to further diminish any potential commercial influences on analytical processes. *S&P* expects to complete this project by June 30, 2009.

Finally, *S&P* has undertaken several measures to strengthen its conflicts detection controls. For example, S&P has recently begun to review the work of analysts who depart *S&P* to work for a rated issuer. *S&P* has also established an Office of the Ombudsman, whose office will endeavor to serve as an independent resource for analytical staff to address issues and concerns raised within or outside of the company. In addition, *S&P* has enhanced the role of various *S&P* and McGraw-Hill committees and ratings committee chairman.

*While S&P conducted a broad review of how it manages its issuer-pays conflicts of interest, and expects to implement new policies that will prohibit both analysts and criteria development staff from engaging in fee discussions, the Staff is concerned that the policies will not prohibit criteria staff from participating in other forms of business discussions prone to conflicts such as market share concerns. The Staff is also concerned about the timeliness of S&P's remedial actions, as full implementation is not expected until the end of 2009.*

### 3. Moody's

*Moody's* conducted a review and as a result, it implemented an email monitoring system that, among other things, will be coded to monitor for fee discussions, considerations of market share and business interests influencing rating decisions. Monitoring procedures were recently completed and test exceptions are being generated. *Moody's* also added compliance staff to monitor, among other things, analyst fee discussions.

The Staff also notes that as a result of its model error review, *Moody's* changed the composition of its surveillance ratings committees to include more independent analysts, in order to further increase the independence of the surveillance process from the initial rating committees.

*While Moody's implemented new policies concerning the issuer-pays conflict of interest, the Staff is concerned that it did not conduct the broad review of how it manages the issuer-pays conflict of interest.*

- The rating agencies varied in how rigorously they monitor or prevent prohibited securities transactions, including personal trading by their employees.

  ***Recommendation: The Staff recommended that all three firms conduct a review of their policies and procedures for managing the securities ownership conflict of interest to determine whether they are reasonably designed to ensure that their employees' personal trading is appropriate and does not violate the Exchange Act.***

### 1. Fitch

In response to the Staff's recommendation, *Fitch* reviewed its policies and procedures for managing employees' security trading. As a result of the review, *Fitch* identified areas to further enhance its policies, and implemented such policy enhancements.

### 2. S&P

In response to the Staff's recommendation, *S&P* engaged a third party to review its policies and procedures for managing employees' securities trading. As part of its efforts to improve its compliance, *S&P* hired a new manager for personal securities trading compliance and is recruiting additional staff to support the function. *S&P* is also amending its policies to expand the use of designated brokers, broadening restricted securities lists, and expanding the pre-clearance controls to include daily (instead of monthly) reports, logs of all violations, and a requirement that transactions effected in violation of the policy be unwound upon discovery. In addition, *S&P* is automating certain compliance processes and controls, and evaluating outside firms to search for undisclosed brokerage accounts. The new policies are expected to be implemented by June 30, 2009.

*The Staff is concerned about the timeliness of S&P's remedial action, as full implementation is not expected until June 30, 2009.*

### 3. Moody's

In response to the Staff's recommendation, *Moody's* reviewed its policies and procedures for managing employees' security trading, focusing on its application to the Structured Finance Group. As a result, *Moody's* is revising its policy to provide more clarity regarding the restrictions on securities trading and ownership for employees in the Structured Finance group. Moody's will prohibit analysts from engaging in transactions of entities that undertake key roles in structured finance transactions, and will maintain listings of such entities to more clearly delineate the issuers whose securities employees cannot own. *Moody's* plans to adopt updated policies by April 30, 2009.

*The Staff is concerned about the timeliness of Moody's remedial action, as full implementation is not expected until April 30, 2009.*

## G. Finding: The rating agencies' internal audit processes varied significantly.

***Recommendation: The Staff recommended that Fitch continue to conduct internal audits and periodically review whether improvements are warranted to its audit program. The Staff recommended that Moody's and S&P review whether their internal audit functions, particularly in the RMBS and CDO ratings areas, are adequate, and whether they provide for proper management follow-up.***

### 1. Fitch

*Fitch* developed procedures for a periodic review of its internal audit policies to ensure that they remain robust. This procedure is complete.

### 2. S&P

Prior to receipt of the deficiency letter, *S&P* began taking steps to improve its internal audit program. To date, *S&P* has hired a new Chief Compliance Officer to oversee compliance controls and monitoring globally for *S&P* Ratings Services. In addition, *S&P's* parent company, *McGraw Hill*, has hired a new regulatory audit manager to conduct internal *S&P* audits. *S&P* also initiated a process to modify its risk assessments and compliance audits to include analyst interviews, file and email reviews. These reviews will result in a report issued to *S&P* senior management.

*S&P* has also engaged an outside law firm to review its internal controls in order to strengthen its compliance monitoring function and business function. *S&P* noted that it currently has 16 people dedicated to quality control activities, including enhancing the quality of ratings models. In addition, *S&P* has 18 staffers working in compliance functions, including a number of dedicated compliance officers for the Structured Finance department.

### 3. Moody's

Prior to receiving the deficiency letter, *Moody's* began taking steps related to the Staff's recommendation. In April 2008, *Moody's* developed internal audit standards that require an annual evaluation of *Moody's* internal audit function. These standards require that the internal audit group submit a three-year audit plan to senior management and the Audit Committee of *Moody's* Corporation Board of Directors on an annual basis. *Moody's* will review the scope of the internal audit function in RMBS and derivatives, as well as the entire rating agency, on an annual basis set forth in the recently adopted audit standards.

After receiving the deficiency letter *Moody's* performed a review of all rating compliance audits conducted during the past two years. As a result, *Moody's* implemented new measures to more fully document management's follow-up to internal audit recommendations. *Moody's* added an appendix to each report that describes management's response as well as the actions taken to each recommendation. *Moody's* Internal Audit Department will review all new audit reports on a quarterly basis to monitor inclusion and completeness of the appendix.

## IV. Conclusion

The rating agencies examined have implemented a number of remedial measures in response to the Staff's deficiency letters. However, the Staff remains concerned about the lack of full implementation of remedial measures at this time. In addition, two of the rating agencies failed to implement the Staff's recommendation with respect to the issuer-pays conflict of interest – specifically to undertake a broad review of their practices, policies and procedures to further mitigate and manage the issuer-pays conflict of interest, including steps that would insulate or prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria. The third firm failed to fully implement corrective measures relating to this conflict. The Staff plans to convey its concerns to the firms in writing and to reiterate these recommendations.