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Moodys SEC Letter to Ray McDaniel

Lori Richards

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
100 F STREET, N.E.
WASHINGTON, DC 20549-8041

July 11, 2008

Via Facsimile and U.S. Mail

Raymond W. McDaniel
President
Moody's Investors Service
99 Church Street
New York, NY 10007

Re: Examination of Moody's Investor Services, Inc.

Dear Mr. McDaniel:

On August 31, 2007, the Office of Compliance Inspections and Examinations, the Division of Trading and Markets, and the Office of Economic Analysis (collectively "the Staff") initiated an examination of Moody's Investor Services, Inc. ("Moody's"). The focus of the examination was Moody's activities in rating subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") linked to subprime RMBS. The examination review period generally covered January 2004 through the present.

Nationally Recognized Statistical Rating Organizations that register with the Commission ("registered NRSROs") are subject to the requirements of the Securities Exchange Act of 1934 ("Exchange Act"). As Moody's registration with the Commission became effective in September 2007, it was not subject to legal obligations applicable to registered NRSROs during most of the review period. The Staff nonetheless sought to make relevant factual findings and observations with respect to the activities of Moody's in rating subprime RMBS and CDOs during the review period, as well as to identify possible areas for improvement in its practices going forward.

The Staff conducted an exit interview with Moody's on June 24, 2008 in which it presented its findings and recommendations. Moody's provided a preliminary verbal response on June 27, 2008. In its response Moody's stated that it generally agreed with the Staff's findings, and also agreed to implement the Staff's recommendations. The Staff's findings and recommendations, and a summary of Moody's responses thereto are set forth below.

1. Staffing Levels

A registered NRSRO is required to maintain adequate financial and managerial resources to produce credit ratings with integrity. From 2002 to 2006, both the complexity and the volume of structured finance deals rated by Moody's increased substantially, as did the revenues Moody's received from rating those deals. The Staff is concerned that the deal and staffing levels during the review period may have impacted aspects of the ratings process, and particularly that CDO staffing levels did not keep pace with volume increases. For instance, several CDO memoranda reviewed by the Staff appear to indicate that ratings were issued notwithstanding one or more unresolved issues.

Recommendation: The Staff recommends that Moody's evaluate both at this time and on a periodic basis whether it has sufficient staff and resources to manage its volume of business and meet its obligations under the Exchange Act.

In its preliminary response, Moody's stated that it agreed with the Staff's recommendation and that it will periodically evaluate staffing levels. The Staff requests that Moody's provide a timetable for its implementation of the recommended action, and the results of its evaluation of its staffing levels and resources.

2. Disclosure of the Rating Process

A registered NRSRO is required to disclose publicly the procedures and methodologies used in determining credit ratings. For the review period, the Staff had difficulty locating the disclosure of certain aspects of Moody's ratings process. Moreover, it appears that Moody's does not publish (or publish before implementation) all incremental changes to its methodology. For instance, the Staff noted in several internal communications that indicated Moody's made changes to its ratings methodology before the market was notified of the changes.

Recommendation: The Staff recommends that Moody's conduct a review of its current disclosures of its processes and methodologies for rating RMBS and CDOs to assess whether it is fully disclosing its ratings methodologies and meeting the requirements of the Exchange Act. Further, the Staff recommends that Moody's review whether its policies governing the timing of disclosure of a significant change to a process or methodology are reasonably designed to comply with these requirements.

In its preliminary response, Moody's stated that it generally agreed with the Staff's recommendations and that it is currently taking steps to improve disclosure of the ratings process, including the drafting of unified methodologies. The Staff requests that Moody's provide a timetable for its implementation of the recommended action, and the results of its review of its current disclosures and applicable policies and procedures.

3. Written Policies and Procedures for Rating RMBS and CDOs

A registered NRSRO is required to make and retain certain internal documents relating to its business, including procedures and methodologies used to determine credit ratings. The Staff reviewed Moody's ratings policies as described in its Code of Professional Conduct, Report on the Code of Professional Conduct, Analyst Handbook – Rating Practices and Procedures, and Moody's Best Practices for the Conduct of Moody's Structured Finance Rating Committees. It appears that while these documents, taken as a whole, provide a general guideline for an analyst to follow when rating structured finance products, they are not specific to any type of structured finance product, such as RMBS or CDOs.

Recommendation: The Staff recommends that Moody's conduct a review to determine whether its 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.

In its preliminary response, Moody's stated that it generally agreed with the Staff's recommendation and that it will conduct a review to ensure that its policies and procedures are properly documented in accordance with the Commission's rules. The Staff requests that Moody's provide a timetable for its implementation of the recommended action, and the results of its review of its written policies and procedures.

4. Documentation of Significant Steps in the Rating Process

A registered NRSRO is required to retain internal records, including non-public information and workpapers, used to form the basis of any credit rating issued. The Staff reviewed a sample of RMBS and CDO deal files to determine if Moody's followed the policies and procedures for rating RMBS and CDOs and its file maintenance and recordkeeping policy. The Staff identified instances in which it appears that Moody's failed to retain or document certain significant steps in the rating process, which made it difficult for the Staff to assess compliance with its rating policies and procedures, and to identify the factors that were considered in developing a particular rating. The Staff notes, however, that Moody's is in the process of implementing automated committee memorandum and other document retention procedures which it asserts addresses these issues.

Recommendation: The Staff recommends that Moody's conduct a review of its current policies and practices for documenting the credit rating process. This review should identify whether the current policies are reasonably designed to ensure compliance with the Exchange Act, and address weaknesses in the policies or in adherence to existing policies that result in gaps in documentation of significant steps in the credit rating process.

In its preliminary response, Moody's stated that it generally agreed with the Staff's recommendation and that it will continue to monitor to ensure compliance with the

Exchange Act and its internal recordkeeping requirements. The Staff requests that Moody's provide a timetable for its implementation of the recommended action, and the results of its review of its policies and practices for documenting the ratings process.

5. Surveillance Practices

A registered NRSRO is required to disclose publicly the procedures and methodologies used in determining credit ratings. In addition, the Exchange Act requires a registered NRSRO to maintain adequate financial and managerial resources to produce credit ratings with integrity. It appears to the Staff that during the review period Moody's regularly performed RMBS and CDO surveillance during the exam period. However, while Moody's published criteria that describe its methodology for the surveillance of RMBS and CDOs, it appears that Moody's does not have internal written procedures documenting the steps staff should undertake for surveillance of RMBS and CDOs.

Recommendation: The Staff recommends that Moody's conduct a review to determine if adequate resources are devoted to surveillance of outstanding RMBS and CDO ratings. The Staff also recommends that Moody's develop comprehensive written surveillance policies and procedures.

In its preliminary response, Moody's stated that it agreed with the Staff's recommendations and informed the Staff that it is implementing, or has implemented, global procedural and structural changes that address the Staff's recommendations. The Staff requests that Moody's provide a timetable for its implementation of the recommended action, and the results of its review of resources devoted to surveillance and documentation of surveillance performed.

6. Management of Conflicts of Interest

It is a conflict of interest for a registered NRSRO being paid by issuers or underwriters to determine credit ratings with respect to securities they issue or underwrite, and a registered NRSRO must establish, maintain, and enforce policies and procedures reasonably designed to address and manage conflicts of interest.

In October of 2007 Moody's established a policy to restrict analysts and their immediate managers from participating in fee discussion with issuers. However, it appears that Moody's does not actively monitor employees' compliance with the prohibition against analysts from participating in fee discussions. There also does not appear to be any internal effort to shield analysts from emails and other communications that discuss fees and revenue from individual issuers. The Staff is concerned that analysts could be influenced in their ratings by their awareness of the amount of fees charged to issuers.

Recommendation: The Staff recommends that Moody's conduct a broad review of its practices, policies and procedures to further mitigate and manage the issuer pays conflict of interest. In particular, the Staff recommends that Moody's consider and implement

steps that would insulate or prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria.

In its preliminary response, Moody's stated that it agreed with the Staff's recommendations and will continue to review its practices and procedures to further mitigate and manage the issuer pays conflict of interest. The Staff requests that Moody's provide a timetable for its implementation of the recommended action, and the results of its review of its practices, policies and procedures for mitigating and managing the issuer-pays conflict of interest. In particular, please describe the steps that Moody's will take to insulate or prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria.

The Staff also reviewed Moody's policies and procedures with respect to securities transactions by its employees. Moody's adopted a policy to prohibit employees and their immediate family members from owning any security that is subject to a credit rating of a team on which such employees are members to guard against potential insider trading. The Staff observes Moody's employee securities transaction program to be generally adequate.

Recommendation: The Staff recommends that Moody's conduct a review of its policies and procedures for managing the securities ownership conflict of interest to determine whether they are reasonably designed to ensure that its employees' personal trading is appropriate and does not violate the Exchange Act.

In its preliminary response, Moody's agreed to continue to review its policies and procedures for securities trading and ownership to ensure compliance with the Exchange Act. The Staff requests that Moody's provide a timetable for its implementation of the recommended action, and the results of its review of its policies and procedures with respect to securities transactions by employees.

7. Internal Audit

Registered NRSROs are required to maintain internal audit plans, reports and related follow-up documents. Moody's performs internal audits to evaluate ratings group's compliance with its best practices, its electronic storage requirements, securities trading restrictions, and the Moody's Code of Conduct. During the review period, Moody's conducted three internal audits related to the RMBS and CDO rating process, however, Moody's was unable to demonstrate evidence of its management's follow-up on the recommendations of the internal auditors. The Staff believes that Moody's should be able to provide records of such follow-ups as part of an examination of the internal audit record.

Recommendation: The Staff recommends that Moody's review whether its internal audit functions, particularly in the RMBS and CDO ratings areas, are adequate, and whether it provides for proper management follow-up.

In its preliminary response, Moody's stated that it agreed with the Staff's recommendation and will review the adequacy of its internal audit functions and will develop procedures that address management follow-up. The Staff requests that Moody's provide a timetable for its implementation of the recommended action, and the results of its review of its internal audit program.

8. Model and Methodology Errors

During the examination, Moody's notified the Staff that it was aware of a coding error in the model Moody's utilized to rate constant proportion debt obligations which resulted in several securities receiving a rating several notches higher than they should have been rated. According to Moody's, its staff breached Moody's Code of Conduct when a monitoring committee took into account the possible damage to Moody's reputation when Moody's Staff decided to maintain the higher unwarranted ratings for several months, and not disclose the coding error. While Moody's has specific policies and procedures that emphasize the importance of providing accurate ratings with integrity, it does not have policies and procedures that provide guidance on the process that should be followed when errors are discovered in its models, methodologies, or other aspects of the ratings process.

Recommendation: The Staff recommends 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 recommends 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. We note that the examination of this issue remains ongoing.

In its preliminary response, Moody's stated that it agreed with the Staff's recommendation, and as a result of these findings outlined above, Moody's has implemented, or plans to implement several global procedural and structural changes that address the issues identified. In its response, Moody's also stated that it has instituted numerous remedial measures to address this issue, including implementing new policies and procedures, and establishing a taskforce to initiate a thorough review of all existing structured finance models. The Staff requests that Moody's provide a timetable for implementation of the recommended action.

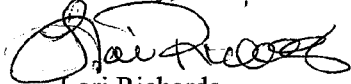
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We are bringing the deficiencies above to your attention for immediate corrective action, without regard to any other action(s) that may result from the examination. The above conclusions are based on the Staff's examination and are not findings or conclusions of the Commission. You should not assume that Moody's activities not discussed in this letter are in full compliance with the federal securities laws or other applicable rules and regulations.

The Staff requests that you provide a copy of this report to your Board and that you schedule a mutually convenient time for the Staff to meet with your Board of Directors to present our findings and recommendations. The Staff requests that Moody's provide a written response to this letter within 30 days outlining any remedial action planned or already taken to address the findings and recommendations in the letter, as well as a timetable for implementing the remedial action. The Staff also requests that Moody's send the Staff written confirmation in six months detailing the status of implementation of each remedial action. Should you have any questions regarding this letter, please contact me at (202) 551-6200 or Duer Meehan at (202) 551-6446.

Thank you for your cooperation in this matter.

Sincerely,

A handwritten signature in black ink, appearing to read "Lori Richards", written over a circular stamp or seal.

Lori Richards

Director

Office of Compliance Inspections and Examinations