Initial Decision Release No. 1167
Administrative Proceeding
File No. 3-16349

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of **Barbara Duka**	**Initial Decision** August 29, 2017

APPEARANCES: Stephen C. McKenna, John Badger Smith, Alfred Day, and Rua M. Kelly for the Division of Enforcement, Securities and Exchange Commission

Guy Petrillo, Daniel Goldman, and Theresa H. Gue of Petrillo Klein & Boxer LLP for Barbara Duka

BEFORE: James E. Grimes, Administrative Law Judge

Summary

At bottom, this case concerns a simple question: whether Respondent Barbara Duka committed fraud to generate business for her employer, Standard & Poor's Ratings Services (S&P).[1] The devil is in the details, however. Resolving the question requires consideration of complex and sometimes arcane concepts concerning how S&P—a nationally recognized statistical rating organization—rates commercial mortgage-backed securities.

The Division of Enforcement contends that Duka changed S&P's methodology for rating commercial mortgage-backed securities to help the company generate ratings business from issuers. Although it is clear that Duka sought to, and did, change S&P's methodology, there is no evidence she did so for a commercial purpose or any reason other than the belief that the change was analytically justified. After

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[1] In 2016, after these proceedings were instituted, S&P changed its name to S&P Global Ratings. S&P Form NRSRO at 2, https://www.standardandpoors.com/en_US/web/guest/regulatory/form-nrsro.

agreeing to do so, however, Duka negligently failed to ensure the change in methodology was disclosed in presale reports distributed to investors.

Based on Duka's negligent omission, I find that she violated Section 17(a)(3) of the Securities Act of 1933 and caused S&P's violation of Section 15E(c)(3) of the Securities Exchange Act of 1934. All other charges are dismissed. For her violations, I order Duka to cease and desist and impose a censure and a monetary penalty of $7,500.

Introduction

In January 2015, the Securities and Exchange Commission instituted this proceeding under Section 8A of the Securities Act, Sections 15E(d) and 21C of the Exchange Act, and Section 9(b) of the Investment Company Act of 1940. In the order instituting proceedings (OIP), the Division alleged that Duka willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5. Alternatively, it alleged that she willfully aided and abetted and caused those violations. The Division also asserted that Duka willfully aided and abetted and caused primary violations of Exchange Act Section 15E(c)(3) and Exchange Act Rules 17g-2(a)(2)(iii), 17g-2(a)(6), and 17g-6(a)(2).

This case was previously assigned to another administrative law judge who scheduled the hearing in this matter to begin on September 16, 2015. *Barbara Duka*, Admin. Proc. Rulings Release No. 2728, 2015 SEC LEXIS 2122 (ALJ May 27, 2015). In July 2015, he granted Duka summary disposition on the Division's allegation that she aided and abetted and caused a violation of Exchange Act Rule 17g-2(a)(2)(iii). *Barbara Duka*, Admin. Proc. Rulings Release No. 2893, 2015 SEC LEXIS 2714, at *4-7 (ALJ July 2, 2015). Later that month, the Commission's chief administrative law judge reassigned this matter to me. *Barbara Duka*, Admin. Proc. Rulings Release No. 2969, 2015 SEC LEXIS 3038 (ALJ July 24, 2015). On August 12, 2015, the United States District Court for the Southern District of New York preliminarily enjoined the Commission from conducting this proceeding. *Duka v. SEC*, 124 F. Supp. 3d 287, *vacated*, No. 15-2732, ECF No. 79 (2d. Cir. June 13, 2016). As a result of the district court's order, I canceled the merits hearing. *Barbara Duka*, Admin. Proc. Rulings Release No. 3030, 2015 SEC LEXIS 3284 (ALJ Aug. 12, 2015).

The Second Circuit later vacated the district court's order. *Duka v. SEC*, No. 15-2732, ECF No. 79 (2d. Cir. June 13, 2016). At the parties' request, I subsequently scheduled the hearing to take place in Manhattan beginning in November 2016. *See Barbara Duka*, Admin. Proc. Rulings Release No. 4185, 2016 SEC LEXIS 3555 (ALJ Sept. 21, 2016). During the nine-day hearing, which occurred on various dates between November 21, 2016, and January 4, 2017, the Division called 11 witnesses, including Duka. Duka called seven witnesses. I admitted 66 of the Division's exhibits and several hundred of Duka's exhibits. I also admitted 85 joint exhibits.

1. Findings of facts

I base the following findings of fact and conclusions on the entire record and the demeanor of the witnesses who testified at the hearing, applying preponderance of the evidence as the standard of proof. *See John Francis D'Acquisto*, Investment Advisers Act of 1940 Release No. 1696, 1998 WL 34300389, at *2 (Jan. 21, 1998) ("[P]reponderance of the evidence . . . is the standard of proof in [Commission] administrative proceedings."). I reject all arguments and proposed findings inconsistent with this decision.

1.1. Background

1.1.1. Commercial mortgage-backed securities

Commercial mortgage-backed securities (CMBS)[2] are essentially a collection of commercial mortgages packaged together and then securitized into bonds to be sold to investors. This packaging is variously referred to as a transaction, a pool, or a deal. Payments to investors are backed by the collection of loans secured by the underlying real-estate collateral. The transaction is structured so that the bonds at the top of the capital structure are paid first and those at the bottom are paid last and thus experience losses first.

The transactions at issue in this case are called "conduit/fusion" deals. In April 2009, such transactions accounted for 85% of the outstanding CMBS market. Joint Ex. 1 at 3. A conduit transaction is a "large pool of diversified small[-]balance loans," and a fusion transaction is a conduit transaction that also includes large loans. Richard Report at 9. S&P defines a conduit/fusion pool as a "pool of at least 40 loans that is diversified by both property type and geography, which may or may not contain several relatively larger-sized loans." Joint Ex. 2 at 3. In a conduit/fusion pool, the ten largest loans will comprise a substantial percentage of the transaction. *See* Richard Report at 9 (at least 50%); Rubinstein Report at 9 (over 30%).

To attract investors, CMBS issuers solicit rating agencies like S&P to rate their offerings.[3] Although S&P occasionally commented on transactions for which it

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2 Because acronyms permeate the industry, their use here is unfortunately unavoidable.

3 *See* Securities and Exchange Commission, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, 21 (Jan. 2003)

was not engaged, *see, e.g.*, Div. Ex. 230, rating agencies typically do not rate transactions for free. They are instead paid to rate transactions by the issuers of those transactions. Tr. 703; *see* Credit Rating Agencies Report at 23, 41.

There are a number of factors involved in an issuer's decision to pick a rating agency but only two matter for present purposes. First, an issuer will typically present investors with ratings from two agencies, one of which will be from S&P, Moody's Investors Service, or Fitch Ratings, Inc. *See* Tr. 72; Rubinstein Report at 14 & n.27. A representative of one investor explained that those "big three" agencies are the most recognized and relied upon by investors.[4] Tr. 879-80. There is evidence that once an issuer obtains a rating from one of the big three agencies, it will not care which agency provides the second rating. Tr. 715; *see* Rubinstein Report at 30. Second, issuers generally pick a rating agency based on which agency will give more bonds in a transaction the best rating. Tr. 510. This will allow the issuer to maximize profits. Tr. 510. As explained by S&P's former head of structured finance, because the most highly rated bonds—those designated as AAA—sell at lower yields and higher prices, the more of these bonds contained in a transaction, the more an issuer will make. Tr. 510-11, 514-15; *see* Tr. 524; *see also* Tr. 1610.

Because rating agencies compete for business and are paid by issuers looking for the best rating, a rating agency could have an incentive to loosen its ratings criteria in the hope of attracting business. *See* Tr. 510-12; Credit Rating Agencies Report at 41. The flip side to this incentive is that if an agency consistently loosens its ratings, those ratings are bound to be deficient and lack credibility. Credit Rating Agencies Report at 41-42. This will ultimately hurt the agency's reputation and thus its business; investors might be less likely to invest in transactions rated by an agency viewed as less trustworthy. *See* Tr. 249, 272. And if issuers know investors will not trust a given rating agency, the issuers will go elsewhere for

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(Credit Rating Agencies Report), https://www.sec.gov/news/studies/credrating report0103.pdf.

4 They are also the longest tenured. When the term "nationally recognized statistical rating organization" was first adopted in 1975, S&P, Moody's, and Fitch were the only statistical rating organizations considered to be nationally recognized. *See* Credit Rating Agencies Report at 8-9. Due to a number of mergers and acquisitions, the same was true as recently as 2003. *Id.* at 5, 8-9. Since then, seven other statistical rating organizations have become nationally recognized. Securities and Exchange Commission Office of Credit Ratings, Current NRSROs, https://www.sec.gov/ocr/ocr-current-nrsros.html#hr.

ratings. In this case, the Division alleges that Duka succumbed to the former incentive to loosen ratings criteria to attract business, thereby committing fraud.[5]

1.1.2. S&P and its ratings of CMBS transactions

When a rating agency rates a CMBS transaction, it is essentially reporting how likely it is that investors will be paid. *See* S. Rep. 109-326, at 2 (2006), https://www.congress.gov/109/crpt/srpt326/CRPT-109srpt326.pdf ("A credit rating is a rating agency's assessment with respect to the ability and willingness of an issuer to make timely payments on a debt instrument, such as a bond, over the life of that instrument."); Richard Report at 21-22; Rubinstein Report at 21. A AAA rating is the highest and means that S&P thinks investors' risk of loss is low. *See* Tr. 41, 58, 61; Rubinstein Report at 21-22.

Ratings analysis begins after the issuer submits "a preliminary collateral pool" to the rating agencies that it is considering engaging for the transaction. Tr. 423. The agencies will have about two weeks to review a "sampling of the loans in the pool," focusing on the top ten loans in the pool. Tr. 423. The agencies then give the issuer their preliminary feedback about the credit enhancement levels—the cushion against loss protecting more senior bonds in a transaction—based on their reviews. Tr. 263-64, 423-24. The issuer will then decide which agencies to engage to rate the transaction. Tr. 424-25. The commercial side of S&P, rather than the analysts, negotiates the engagement with an issuer. Tr. 422-23.

Credit enhancement is also called credit support or subordination, and refers to the percentage of losses in a pool that would occur before the AAA level of the transaction would experience losses and corresponds inversely to the amount of AAA bonds that can issue. Tr. 59, 263-64, 695, 881. A credit enhancement level of 20% in a $100 million loan pool would mean that the pool would have to experience 20% in losses before the AAA level would experience losses. Tr. 59, 263-64, 881. Credit enhancement is designed so that lower classes of bonds would suffer losses before higher classes. Tr. 510-11. Issuers tend to pick the rating agency that assigns a lower credit enhancement level to the transaction because this allows the issuer to issue more AAA-rated bonds, which is economically more attractive to the issuer. Tr. 71, 425.

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[5] S&P settled charges related to the events at issue in this case. *Standard & Poor's Rating Services*, Securities Act Release No. 9705, 2015 WL 252448 (Jan. 21, 2015). The findings announced under S&P's settlement "are not binding on" Duka or "any other person." *Id.* at *1 n.1. The findings therefore have no bearing on this proceeding. *See also Rodney R. Schoemann*, Securities Act Release No. 20769076, 2009 WL 3413043, at *13 n.55 (Oct. 23, 2009) ("settlements can be reached for any number of reasons[] and . . . are not precedent"), *aff'd*, 398 F. App'x. 603 (D.C. Cir. 2010).

Once engaged, S&P will conduct a more thorough review. Tr. 425-26. In addition to reviewing the loans and associated documents, analysts will consider third-party data and visit various properties that serve as collateral in hopes of gauging each property's value and expected cash flow. Tr. 426-27.

Near the end of this process, S&P gives the issuer final feedback and convenes a rating committee to determine preliminary ratings. Tr. 427-28. After the committee meets and considers any additional information about the final capital structure of the transaction supplied by the issuer, S&P will issue preliminary ratings and a presale report. Tr. 428. The presale report is a public document listing the preliminary ratings for the securities being offered in the transaction and describing the rationale for the ratings. *E.g.*, Joint Ex. 18. The issuer will then market the transaction and it will close. Tr. 429. After that, S&P issues final ratings, taking into account any interim changes in the transaction. Tr. 429. The ratings process for such transactions, from engagement to final rating, typically takes two months. Tr. 429-30.

Neither a preliminary nor a final rating at S&P can be determined without a rating committee vote. Tr. 430. The rating committee is composed of analytic personnel in S&P's CMBS group. *See* Tr. 430. The committee members are given a Rating Analysis Methodology Profile, abbreviated as RAMP. Tr. 430-31. The RAMP is the primary document considered by the rating committee and serves as a record for later review. Tr. 770. The RAMP is prepared by the primary analyst and summarizes the analysis of the transaction and supports the recommended rating. Tr. 431, 770-72, 1746; *see* Tr. 331. It also documents the rating committee's discussions about the rating. Tr. 1207. Although the primary analyst is principally responsible for assembling a RAMP, somewhat of a group effort is typically involved. Tr. 770-72. The primary analyst will assemble the RAMP in piecemeal fashion as information is gathered, which includes populating a template with "deal-specific information." Tr. 770-71.

Under S&P guidelines, the RAMP should provide the "key assumptions used in the model and the reasons for their use." Div. Ex. 196 at 5. If there are a range of assumptions, the RAMP should also explain why the analyst selected a particular assumption. *Id.* The rationale for "material differences between [a] [c]redit [r]ating implied by [a] model and the final [c]redit [r]ating . . . or credit enhancement" level also should be documented in the RAMP. *Id.* During the hearing, one analyst characterized a rating committee meeting as "a forum to kind of discuss the analysis that was done, the inputs[,] and what the ultimate rating recommendation is." Tr. 831.

The models S&P uses to rate a transaction and its constituent loans are complicated. *See* Div. Ex. 355; Div. Ex. 336. The specifics of these models are notably not disclosed to investors. Tr. 2076-77; *see* Tr. 2082-83. In essence, the models attempt to predict the number of loans in a pool that will default during the terms of the loans and how many will default at maturity.[6] Rubinstein Report at 38-39. To calculate whether a loan will default during its term (referred to as a term default), S&P calculated the debt service coverage ratio, which is the ratio of net cash flow to debt service on an annual basis—in other words, whether there is enough cash coming in to cover the principal and interest owed on the loan. Tr. 64. In S&P's model, the loan is considered a default if two conditions occur: (1) the debt service coverage ratio is less than 1.0, which happens if debt service exceeds net cash flow (*i.e.*, there is insufficient cash to cover loan payments) and (2) the loan-to-value ratio on the property is more than 100%, (*i.e.*, the loan balance exceeds the value of the property, meaning the loan is underwater). Tr. 114-15, 472; Joint Ex. 2 at 16-17. It is also considered a default if loan-to-value is between 90% and 100% and the debt service coverage ratio is less than the loan-to-value—that is, the borrower still retains a small amount of equity but the property cannot cover its loan payments. Joint Ex. 2 at 16-17. Only loans that did not default during their terms were tested at maturity. Tr. 473. Under S&P's guidelines, a balloon default, or a maturity default, occurs if the loan-to-value ratio at maturity is projected to exceed 100%. Joint Ex. 2 at 18.

The annual debt service—the amount owed on a loan in a year—is calculated by multiplying a loan constant—a figure of some import in this case—by the loan balance. Tr. 65. In other words, a loan constant represents the interest and principal being paid on a loan as a percentage of the loan balance. Tr. 462, 1260. Loan constants will vary in proportion to changes in interest rates. Tr. 462; *see* Tr. 1260. During the hearing, witnesses expressed disagreement about whether the loan constant should be calculated based on the fixed, contractual terms of the loans in question or whether the constant should be "stressed" in order to mimic adverse economic conditions.[7] A central issue in this case concerns how S&P calculated the loan constants for eight transactions rated in 2011. *See* OIP ¶ 6. Deciding which constant is used matters because as the number of predicted defaults in a pool grows, the percentage of a given pool that is rated AAA declines and the amount of "credit enhancement" increases. *See* Joint Ex. 2 at 11; Tr. 1711. And as credit enhancement increases, the issuer's potential profit decreases. *See* Tr. 71, 425.

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[6] Various types of loans were addressed during the hearing. These included interest-only loans, fully amortized loans, and loans amortized over multiple years with a "balloon" payment due after ten years. Tr. 114, 350, 363, 471, 1291-93.

[7] One way to stress a loan is to apply a constant that is higher than the actual, contractual loan constant. Tr. 194; *see* Tr. 113 (testifying that the coupon "for an amortizing loan would be lower than the [stressed] constant").

1.1.3. The relevant personnel at S&P

The relevant time period in this case is 2009 through 2011. For the most part, the pertinent internal structure of S&P at the time and the people who occupied relevant positions in the company is depicted in Division Exhibit B-1, which is attached to this initial decision as an addendum. For our purposes, two separate divisions within S&P are relevant. On one side of the divide was the CMBS ratings group. During the relevant time period, the CMBS ratings group was further subdivided into two groups, new issuance and surveillance. Joint Ex. 85 at 1-2. In simple terms, new issuance rated new transactions and surveillance monitored S&P's ratings of outstanding securities. Tr. 38; *see* Tr. 42-43 (describing surveillance's monitoring and review function). Duka was in charge of new issuance and, until January 2011, Eric Thompson ran surveillance.[8] Tr. 38-39, 432. After Thompson left, Duka assumed responsibilities for surveillance as well. Tr. 420, 1108, 1112. Until August 2010, Thompson and Duka reported to Kim Diamond, who reported to David Jacob, the head of structured finance. Div. Ex. B-1; Joint Ex. 85 at 2. From August 2010 onward, Thompson and Duka reported to Grace Osborne. Div. Ex. B-1; Joint Ex. 85 at 2.

Duka graduated from Rutgers with a degree in economics. Tr. 1107. She began at S&P in the late 1990s as an analyst. Tr. 1107-08. She was promoted several times, reaching the position of manager of new issuance in late 2008. Tr. 1108-10. As manager or co-manager of CMBS, her primary responsibilities included managing the rating process, identifying changes to the criteria used to rate CMBS transactions, and managing development of the model used to rate transactions. Tr. 1110-11. Prior to the financial crisis, CMBS employed between 40 and 50 people. Tr. 1162. In 2008 and 2009, employees were shifted from new issuance to surveillance such that by 2009, only five or six people reported to Duka. Tr. 1163.

Duka supervised Kurt Pollem and David Henschke. Div. Ex. B-1; Tr. 1715-16. She periodically supervised James Digney, who worked in new issuance from 2005 until the fall of 2009, in surveillance from 2009 to March 2011, and in new issuance again after that. Tr. 417-21. Brian Snow was an analyst who worked under Pollem's supervision. Tr. 1740.

On the other side of the divide from the CMBS ratings group were the keepers of the criteria S&P used to analyze transactions and issue ratings. As will become evident, whoever created this structure was particularly fond of the word "quality." The groups on this side of the divide were the criteria group, model quality review group, and quality review group. With some exceptions, the exact nature of the seemingly overlapping responsibilities of the personnel in these

[8] Thompson became the co-head of the CMBS group focused on surveillance in 2008. Tr. 38. He held that position until he left S&P in January 2011. Tr. 39.

similarly named groups is not especially relevant. Because the names of these individuals will come up later, however, I briefly review their names and responsibilities here.

Mark Adelson, S&P's chief credit officer, was responsible for the criteria group and the model quality review group. *See* Div. Ex. B-1. Neri Bukspan, the chief quality officer, was responsible for the quality review group. *Id.* Adelson and Bukspan each reported to Patrick Milano, the executive vice president of operations. *Id.* Milano has worked for S&P or its parent, McGraw-Hill (now S&P Global), for 35 years. Tr. 208.

Bukspan supervised Susan Barnes, quality officer for structured finance. Div. Ex. B-1. Bukspan's "quality group" oversaw "reviews and procedures conducted on the ratings process itself." Tr. 214-15. This responsibility entailed "reviewing documentations [and] reviewing criteria application to ratings." Tr. 215. The quality group "was responsible for ensuring compliance by S&P's analysts with criteria and internal ratings processes." Joint Ex. 85 at 3.

Under Adelson, the criteria group was responsible for overseeing, updating, and amending criteria. Tr. 212. As his responsibilities related to CMBS, Adelson supervised Frank Parisi, the chief credit officer for global structured finance, and Parisi's subordinate, Majid Geramian, criteria officer for global CMBS. Tr. 251, 1483; Div. Ex. B-1.[9] Jim Manzi was the criteria officer for CMBS from the fall of 2009 until the summer or fall of 2010. Tr. 1490; Joint Ex. 85 at 3. He was replaced in mid-December 2010 by Geramian. Tr. 1490. In the interim between Manzi and Geramian, Parisi served as the CMBS acting criteria officer. Tr. 648, 1491; *see* Resp. Ex. 233.

Also under Adelson's supervision, the model quality review group reviewed ratings models and analytical processes and ensured that the models produced appropriate outcomes. Tr. 214; Joint Ex. 85 at 3. This group was managed by Martin Goldberg, who supervised Haixin Hu, an associate director in the group. Tr. 214; Div. Ex. B-1.

1.2. The criteria article

1.2.1. Events leading up to criteria article

Central to the parties' dispute is a "criteria" article S&P published in June 2009, purportedly to announce how it would rate CMBS conduit/fusion pools. *See*

[9] Division exhibit B-1 mistakenly identifies Parisi as chief *criteria* officer for structured finance. His formal title was instead chief *credit* officer for structured finance. *See* Resp. Ex. 528 at 1; Tr. 1483.

Joint Ex. 2 at 4. Specifically, the parties dispute whether this article announced to the market that S&P would use actual constants or that it would use stressed constants, which are more stringent and lead to more conservative ratings. As will become clear, the allegations in the case concern the decision to switch from rating conduit/fusion transactions using stressed constants from the criteria article—referred to as "Table 1" constants—to using a blend of Table 1 and actual constants.

Relevant to the development of the criteria article, Jacob, the head of structured finance, testified that by the time he arrived at S&P in 2008, structured finance "was in shambles." Tr. 518. Revenue had declined precipitously, there were almost no new transactions to review, and morale was low. Tr. 518-19. Jacob also explained that S&P had established "a strict separation between the business" side of the firm and the side that developed ratings criteria. Tr. 517. It was therefore the case that he was not involved in developing ratings criteria. Tr. 517.

Adelson also joined S&P in 2008, a few months before Jacob. Tr. 248. As noted, Adelson was responsible for the criteria group and the model quality review group, as well as S&P's economists and the global fixed income research group.[10] Tr. 251; Div. Ex. B-1. Adelson was not a wilting flower. One subordinate said that he was demanding, had a strong personality, and intimidated some people at S&P. Tr. 1488-90. Jacob said that although Adelson would not be a good manager, he "had a reputation . . . as a strong analyst." Tr. 514, 516. Jacob said that Adelson was "[s]omewhat controversial, because he's very, very tough and strong-minded and principled. And almost even scary at times. But very, very honest and straight, the most straight-shooter you could find." Tr. 516. Adelson's lengthy answers during the hearing, often exceeding the scope of the questions he was asked, bore witness to the degree to which he believed in his opinions. *See* Tr. 300-01, 348-49, 357.

Adelson testified that in competing for ratings business, rating agencies can succumb to pressure to "win . . . deals"—to be hired to rate a transaction. Tr. 253. He opined that this pressure leads to "competitive laxity," the loosening of ratings in order to win business. Tr. 253; *see* Tr. 263. According to Adelson, S&P's reputation had been hurt in the past due to the poor performance of many of its ratings. Tr. 249; *see* Tr. 272. S&P leadership thus decided in 2008 to "implement[] a structure of controls." Tr. 248; *see* Tr. 249, 253-54. As part of that effort, S&P hired several people, including Jacob and Adelson. Tr. 248-49, 514.

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10 After receiving his law degree, Adelson worked at a Manhattan law firm before moving in 1991 to Moody's, where he worked in structured finance. Tr. 245-46. In 2001, he moved to Nomura Securities, where he was the head of structured finance research reporting. Tr. 246. In these latter two capacities, he published articles related to credit analysis, credit issues, and the credit rating business. Tr. 246. Adelson left Nomura in 2007 to start his own consulting business with Jacob. Tr. 247.

At some point after Adelson started at S&P, it began taking steps to combat the competitive laxity to which Adelson referred. Tr. 255. S&P divided its internal structure to separate commercial activities, such as fee negotiations with issuers and banks, from analytic activities, such as the development of ratings. Tr. 254.

During the same time, a concern arose that S&P needed to explain the rationale it would follow in rating CMBS transactions.[11] Tr. 260. To achieve greater transparency, Adelson worked to develop a "criteria" article designed to unify and harmonize what S&P's ratings actually meant. Tr. 267-70. Adelson explained that criteria referred to "principles, methodologies[,] and assumptions for assigning credit ratings to bonds and issuers." Tr. 268; *see* Joint Ex. 85 at 2. Adelson saw development of the article as part of an effort to restore trust in S&P's ratings and to be transparent about how S&P arrived at its ratings. Tr. 271-73. In his mind, the goal was that an outside analyst who used S&P's criteria could come within a "notch" of S&P's final actual rating "at least half the time."[12] Tr. 273-74.

Adelson also explained that after years of eroding credit enhancement levels, he felt S&P needed to restore the levels. Tr. 264-65. After historical research, he concluded that a standard AAA rated transaction should have a credit enhancement level of 19%. Tr. 265.

Thompson and Duka were also involved in the development of the criteria article. Tr. 55-56; Joint Ex. 2 at 1. Thompson understood at the time that in order to constitute official S&P criteria, the criteria had to be published. Tr. 141-42. And criteria would clearly be labeled as criteria. Tr. 145; *see* Resp. Ex. 165 at 3. The criteria development process was documented in notes of the criteria committee's meetings beginning May 8, 2009. *See* Resp. Exs. 108-19. After four meetings, S&P published a request for "comments on its proposed changes to its methodology and assumptions for rating" conduit/fusion transactions. Joint Ex. 1 at 3. The request contained a table titled "prototypical CMBS conduit/fusion pool" that, among other things, purported to list loan constants for five property types. *Id.* at 6. Consistent with S&P's then-existing practice, *see* Tr. 461, 1263, it also contained a table showing figures calculated using an actual constant, *i.e.*, the contractual constant,

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11 According to Adelson, a concern arose about S&P's need to comply with the requirements of the Federal Reserve's Term Asset-Backed Securities Loan Facility program. Tr. 260; *see* 12 C.F.R. § 201.3(e); *see also* Tr. 52-53; U.S. Department of the Treasury, *Term Asset-Backed Securities Loan Facility*, https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/credit-market-programs/talf/Pages/default.aspx (last updated Mar. 10, 2014).

12 When asked about the term "notch," Adelson said "[i]f you came out at AA and the actual rating was AA-, that's within a notch. If you came out at AA+ and the actual rating was AA-, that's two notches." Tr. 274.

rather than those listed in the prototypical pool. Tr. 132; *see* Joint Ex. 1 at 11. The response to the request for comment was quite negative. Tr. 132; *see* Resp. Ex. 140 at 1; Div. Ex. 343. Among the complaints aired by market participants were concerns that S&P's proposed 20% credit enhancement level was "arbitrary and irresponsible." Div. Ex. 343 at 1.

S&P published its criteria article for conduit/fusion transactions in June 2009, announcing that it was changing "its methodologies and assumptions for determining credit enhancement levels and ratings for CMBS conduit/fusion pools."[13] *See* Joint Ex. 2 at 4. Jacob testified that Duka opined to him at the time that the rating criteria described in the article "were conservative and [were] not going to be so accepted by the marketplace." Tr. 525. If Duka expressed this view, she was right; S&P's criteria were viewed as too conservative and the industry response was negative.[14] Tr. 201, 895-97, 1041-42, 1044; *see* Resp. Ex. 140 at 1 (comments regarding S&P's request of comment); Div. Ex. 343 (same).

In the criteria article, S&P defined a conduit/fusion transaction as a "deal[] that include[s] a pool of at least 40 loans that is diversified by both property type and geography, which may or may not contain several relatively larger-sized loans." Joint Ex. 2 at 3. S&P explained that it was "establish[ing] . . . a 'AAA' credit enhancement level that is sufficient . . . to enable tranches rated at that level to withstand market conditions commensurate with an extreme economic downturn without defaulting." *Id.* at 4. The article referred to an "'archetypical' pool" possessing "an S&P loan-to-value (LTV) of 90%[,] . . . an S&P debt service coverage (DSC) of l.2x," and a 19% credit enhancement level.[15] *Id.* at 4, 6. The stated purpose of this archetypical pool was to serve "as a general benchmark against which other conduit/fusion deal pools can be compared." *Id.* at 5.

The criteria article contained a table labeled "Table 1" and titled "Archetypical CMBS Conduit/Fusion Pool." Joint Ex. 2 at 5. As noted above, the import of Table 1 is at the heart of the parties' dispute.

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13 S&P published criteria articles for other types of transactions, as well. Tr. 56-57. The conduit/fusion criteria article is the one relevant to this proceeding.

14 Duka denied thinking in terms of whether the criteria were too conservative. Tr. 1164. She said that she instead thought in terms of whether the criteria made sense. Tr. 1164-65.

15 The term debt service coverage was defined as "[t]he ratio of a real property's [net cash flow] to the scheduled debt service expressed as a multiple (e.g. 1.2x)." Joint Ex. 2 at 30.

Table 1 listed 100 loans with a loan-to-value ratio of 90% and a debt service coverage of 1.2x. Joint Ex. 2 at 5; *see id.* at 27 ("We assume that the archetypical pool would have 100 loans"). As noted, before the publication of this article, S&P calculated debt service coverage using a loan's actual debt service and thus an actual loan constant. Tr. 461, 1263. The criteria article, by contrast, listed loan constants for five different property types: retail, 8.25%; office, 8.25%; multifamily, 7.75%; lodging, 10.00%; and industrial, 8.50%. Joint Ex. 2 at 5. These figures matched those in the prototypical pool found in the earlier request for comments. *See* Joint Ex. 1 at 6.

The exact basis for these constants is not clear. According to Thompson, the criteria committee came up with these constants during a discussion of the then-current "interest rate cycle and just what was going on in regard to commercial real estate lending." Tr. 66; *see* Tr. 195-96. The committee's members put the numbers on a whiteboard, made some revisions, and decided to use the numbers that were eventually listed in Table 1. Tr. 65-66. Thompson made no mention of empirical data being used to arrive at the numbers. *See* Tr. 65-66, 120. He opined that the minutes of the criteria committee's meetings should have documented the committee's vote to use the constants listed in Table 1. Tr. 120.

Notes from the criteria committee's May and June 2009 meetings leading up to the publication of the criteria article, however, do not reveal any discussion about the figures in Table 1 or the use of Table 1 constants to compute debt service in actual transactions. *See* Resp. Exs. 109-18; Tr. 1281. They also do not reflect any discussion about how the figures were derived. *See* Resp. Exs. 108-19. Instead, the minutes only reflect that (1) on May 8, 2009, the committee considered options "for determining a maturity default[,] includ[ing,] . . . us[ing] predetermined loan constants and minimum [debt service coverage ratios]"; and (2) on May 17, 2009, the committee decided that constants for a "prototypical pool" should be "8% for all prop types except 10% for hotels." Resp. Ex. 108 at 2; Resp. Ex. 109. As Table 1 eventually reflected, however, the figures listed in the minutes from May 17, 2009, were not used. Joint Ex. 2 at 5. There is therefore no specific information about how S&P's criteria committee developed the figures in Table 1.[16] Given the minutes of the criteria committee and Thompson's testimony, I am left to conclude that the committee arrived at the constants in an ad hoc fashion and settled on them for no particular reason other than a general feeling that they seemed appropriate.

As a factual matter, the criteria article is confusing. The exact point of publishing the Table 1 constants is not evident from reviewing the criteria article

[16] Notes for criteria committee meetings on May 8 and 17, 2009, each include a chart labeled "prototypical pool." Div. Ex. 108 at 1; Div. Ex. 109 at 1. The chart in each is similar to Table 1, but neither chart in the notes lists the loan constants used in Table 1. Div. Ex. 108 at 1; Div. Ex. 109 at 1.

itself. Consistent with the idea that the Table 1 constants were intended to serve as a "benchmark," the criteria article provided that actual credit enhancement levels would vary depending on the relative strength of the actual pools in question.[17] Thompson agreed that the article did not say that Table 1 constants would be used to evaluate actual pools and that it was unclear about how the Table 1 constants would be used. Tr. 111. But he testified that he thought the Table 1 constants would be used going forward for rating conduit/fusion transactions. Tr. 66; *see* Tr. 193-94. This latter testimony, however, was somewhat undercut by an e-mail Thompson wrote in December 2010, in which he said "the criteria [article] doesn't stipulate that we have to use loan constants listed." Resp. Ex. 334 at 2.

By contrast, because the loans in the pools in question would have actual, contractual debt service that did not need to be calculated, Duka thought the Table 1 constants would be used for comparison purposes. Tr. 1282; *see* Tr. 1288. She viewed the Table 1 constants as being part of a description of the archetypical pool. Tr. 1116. Duka also did not view them as stressed loan constants, although that is the way they were used. Tr. 1117-18. Duka did not believe that the criteria article required the use of Table 1 constants but rather called for the use of actual constants. Tr. 1147-50.

Adelson essentially confirmed Duka's assessment. After conceding that the first few criteria articles—more articles followed the June 2009 article—were not "as detailed and specific and clear as they should have been," Tr. 274-75, Adelson said that the June 2009 criteria article was "lousy" because it "left stuff out that should have been in it that was part of how ratings were done."[18] Tr. 370. When Duka's counsel posited to Adelson that the criteria article did not state or suggest that Table 1 constants would be used in rating future transactions, Adelson responded that he "ha[d] to agree . . . that the article . . . leaves something to be desired on that score." Tr. 364-65; *see also* Tr. 344 (conceding the "construction" of Table 1 was "inartful presentation"). It is difficult to argue with Adelson's understatement.

There is more. Adding to the confusion about Table 1 constants, the criteria article contained a "Table 6" titled "Suburban Office Building Analysis." *See* Joint

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17 *See* Joint Ex. 2 at 6; *see id.* at 14 ("[Q]ualitative determination may be used to adjust credit enhancement upward for pools that have significant event risk due to high concentrations by property type and/or geography."); *id.* at 19 (noting that the absolute floor for AAA credit enhancement for pools with "exceptional creditworthiness" would be 10%).

18 Adelson was not alone. A representative of one investor said that with respect to the request for comment, "we had probably more questions than answers in looking at the document." Tr. 926.

Ex. 2 at 16. Although Table 1 called for a loan constant of 8.25%, or 0.0825, for office buildings, *id.* at 5, Tr. 106, calculations based on the figures listed as an example in Table 6 revealed that the loan constant for the example in Table 6 would be 0.07983, Tr. 348-52; *see also* Resp. Ex. 123 at 5; Resp. Ex. 695D. Witnesses agreed that this figure was the actual constant, rather than the Table 1 constant. Tr. 108-09, 352, 1271-72, 1286-87.

As noted, the criteria article's glossary defined the term "debt service coverage" as "[t]he ratio of a real property's [net cash flow] to the scheduled debt service expressed as a multiple (e.g. 1.2x)." Joint Ex. 2 at 30. Thompson professed uncertainty about this definition but offered that normally the term "scheduled debt service" refers to debt service under the terms of the loan in question. Tr. 109. In other words, this definition in the glossary also seemed to suggest that S&P would use actual constants.

Thompson agreed that if the mix of properties, concentration, or geographic mix in an actual transaction varied from that found in the archetypical pool, analysts would make adjustments in the credit enhancement level for the transaction. Tr. 99-100. Likewise, although the archetypical pool envisioned a loan-to-value ratio of 90%, actual loan-to-value ratios would be evaluated on a "loan-by-loan" basis. Tr. 101-02.

According to Adelson, changes to criteria could only be made through the process presented in a series of documents called the rating services criteria process guidelines. *See* Joint Exs. 9-11; Tr. 282-83. He was involved in developing the first criteria process guidelines, which were published in December 2009. Tr. 276-78; *see* Joint Ex. 9. The guidelines, which were published internally, were mandatory for S&P analysts. Tr. 279-80. This was supposed to ensure that analysts used the same process and produced consistent results. Tr. 280.

The criteria change process guidelines article in effect for most of the relevant events was issued in September 2010. Joint Ex. 10 at 1. It describes a five-step process for changing ratings criteria: initiation, research, approval, dissemination, and periodic review. Tr. 283, 287; *see* Joint Ex. 10 at 6-16. By the guidelines' terms, however, this process did "not apply to *interpretations* of the application of [the] criteria to a particular circumstance which are expected to occur as a natural by-product of our analysis and committee process." Joint Ex. 10 at 1 (emphasis added); Joint Ex. 9 at 1; *see* Tr. 281, 373-74.

The guidelines gave criteria officers significant responsibilities.[19] Recall that criteria officers worked on Adelson's side of the divide, not on Duka's and

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[19] Each practice group in CMBS had a criteria officer. CMBS's criteria officers during the relevant time reported to Parisi, the chief credit officer for structured

Thompson's. According to Adelson, criteria officers primarily served a "control function" and also "serve[d] as a resource, internal consult[ant], [and] reservoir of knowledge." Tr. 373. They were also "specific[ally] responsib[le]" for "serv[ing] as a resource with regard to the procedure governing the criteria process." Tr. 373.

The guidelines provided that any questions about the guidelines should be addressed to the criteria officer or any departmental or regional senior credit officer. Joint Ex. 10 at 1. Further, in the process of deciding whether to initiate the five-step process, criteria officers "should decide when to explore issues that come to light during the criteria process." *Id.* at 8. "[T]he best approach" was "to consult the relevant Practice Criteria Officer or [departmental credit officer] regarding the process for initiating changes." *Id.* And if an analyst identified an issue, it would have been up to the criteria officer to appoint a "criteria champion," to "steer[] the process of creating new criteria or revising existing criteria." *Id.* at 2, 8. Within the approval process itself, the criteria officer was "responsible for escalating issues when any of" a defined set of "conditions appl[ied]." *Id.* at 13.

Adelson opined that the language about interpretations was designed to cover unanticipated situations. Tr. 281. He also believed that the language applied to "one-off" situations and that if an issue was likely to recur, the issue would have to be addressed in a new criteria article. Tr. 282, 402. At some point, Adelson informed his subordinates of his view that the term "interpretation" had a limited scope. Tr. 403-04. He conceded that his subordinates only developed this understanding "later on" because "there [was not] much discussion" of the issue earlier in the process. Tr. 403-04.

Adelson also opined that a criteria change would refer to a situation in which S&P would change its ratings method "for the whole population of bonds covered by that criteria." Tr. 282. And a criteria change must be documented. Tr. 283. Adelson said that an interpretation should be documented in a presale in order to be transparent. Tr. 283-84.

Adelson's subordinate Parisi testified that the notion of an "interpretation" referred to "a unique circumstance" and opined that it might be implicated if the criteria article were unclear. Tr. 1506-07. He thought the guidelines would apply to an "across-the-board" change. Tr. 1507. Parisi was asked whether the analytical staff was aware of this distinction. Tr. 1508. He thought there was some awareness among staff members but ultimately concluded that he could not say for certain whether they all understood it. Tr. 1508-09. Parisi opined that the criteria process guidelines were mandatory. Tr. 1509. On cross-examination, Duka's counsel

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finance, who reported to Adelson, and who served as a CMBS criteria officer until mid-December 2010. Tr. 648, 1483, 1490-91; Div. Ex. B-1.

demonstrated that there were instances in which interpretations could apply to more than a single transaction. Tr. 1553-54.

The guidelines contemplated appeals and provided that analysts and managers could “appeal existing or new criteria for any analytic reason.” Joint Ex. 10 at 17. Under “approval,” the third of the five steps in the criteria process, the guidelines provided that if certain conditions applied, “analytic issue[s] and [their] related criteria should be escalated to the chief credit officer or the [Analytics Policy Board],” which was the “final level of appeal/escalation.” Joint Ex. 10 at 12-13, 17; Tr. 335. The first level of any appeal or “escalation” regarding new or existing criteria is to the criteria officer. Joint Ex. 10 at 17. Indeed, in advertising for a replacement for Manzi, Parisi drafted a criteria officer job description in which he explained that criteria officers “[m]ake final interpretations of criteria for his/her coverage area (subject to escalation process in the case of a disagreement).” Resp. Ex. 238 at 2; *see* Resp. Ex. 528 at 1 (Parisi stating that “[t]he interpretation of criteria resides with criteria - application resides with the ratings practice”). According to Parisi, a criteria officer could decide whether something represented an interpretation. Tr. 1549. Duka similarly understood the guidelines to mean that if the criteria officer concluded that a change was an interpretation, the five-step process did not apply. Tr. 1246-47.

Adelson held a different view. Notwithstanding the language that “[t]he first level of appeal/escalation is to a Practice Criteria Officer,” Adelson disputed that “the first stop is the criteria officer.” Tr. 338. He stated instead that “this is going to the criteria officer’s boss,” and added, apparently as justification, “I wrote it.” Tr. 338. He did not explain how or why others would have held this counter-textual view. Adelson conceded, however, that process questions should be directed to the practice criteria officer. Tr. 338.

As noted above and discussed more fully below, the allegations in this case concern the decision to switch from rating transactions using Table 1 constants to using a blend of Table 1 and actual constants. Adelson characterized this switch as a criteria change rather than a criteria interpretation because it “affect[ed] how [S&P] . . . assign[ed] ratings to all the CMBS.” Tr. 286. He added that it implicated certain conditions in the guidelines, including a loosening of assumptions and “meaningful franchise or reputational risk.” Tr. 289-90; *see* Joint Ex. 10 at 13. Adelson conceded, however, that if an analyst took an issue to a criteria officer because the issue appeared to present such risk, the criteria officer had the authority to decide such risk was not presented. Tr. 405-06. In other words, if the criteria officer decided the issue did not present reputational risk, the discussion “would stop with him.” Tr. 406; *see* Tr. 408; Joint Ex. 9 at 12 (“Criteria officers are responsible for escalating issues when any of the foregoing conditions apply.”).

1.2.2. Meetings after S&P published the criteria article

In late July 2009, a disagreement arose about calculating loan constants and their usage in both the term and maturity default tests. *See* Div. Ex. 45; Tr. 80. The disagreement, between Tom Gillis, the chief credit officer for global structured finance, and Manzi, the CMBS criteria officer, Tr. 80, concerned whether Table 1 constants should be used, Tr. 80, 148-50. At the behest of Deven Sharma, who was S&P's president, Milano called a meeting attended by Adelson, Jacob, and others to address the use of loan constants and a "game plan for moving forward with surveillance of CMBS." Tr. 79; Div. Ex. 45. The invitee list did not include all members of the criteria committee, the analytic policy board, or the structured finance committee. Tr. 154-55. Apparently because the meeting concerned a "game plan" for surveillance, neither Duka nor any member of new issuance attended the meeting. Tr. 157.

Especially because Manzi and Gillis were in attendance, Thompson assumed that one of the attendees would have taken notes. Tr. 155-56. No notes were offered into evidence during the hearing, however. Apparently, none were taken. The discussion chiefly concerned whether the criteria article required the use of Table 1 constants. Tr. 156. Thompson testified that a decision was reached—he did not say by whom—that analysts were to use Table 1 constants for both the term and maturity default tests. Tr. 81, 156-57. Logically, because the criteria article said nothing about how Table 1 constants were to be used, one might think that this change would be subject to the criteria change process and, ultimately, to publication. But no evidence was presented about the then-existing criteria change process.[20]

In any event, the decision to use Table 1 constants was not published externally. Under later guidelines, this fact and the fact the criteria committee was not involved would suggest that the decision was an interpretation. Tr. 283, 1295; *see* Joint Ex. 10 at 3 ("'Criteria' encompasses all *published* guidance that governs the analytic basis for determining ratings." (emphasis added)); Joint Ex. 9 at 3 (same). Indeed, Duka understood the decision made at the July 2009 meeting to be an interpretation rather than a criteria change. Tr. 1124-25; *see* Tr. 1142.

The decision to use Table 1 constants was also not published internally. Duka only learned of the July 2009 meeting and resulting decision after Thompson later called a meeting of CMBS staff to relay what had been decided. Tr. 1289-91; *see* Tr. 1124. Given the transactions surveillance reviewed, Duka understood Thompson's concern—the reason he had raised the issue—to relate to interest-only loans, which

[20] The earliest process guideline in evidence took effect December 3, 2009, several months after the July 2009 meeting. *See* Joint Ex. 9 at 1. The December 3, 2009 guideline replaced a guideline dated November 25, 2008. *Id.*

made up a large portion of surveillance's portfolio. Tr. 1291-93. Consistent with Duka's understanding, Thompson conveyed that the decision to use Table 1 constants was an interpretation because the criteria article did not address interest-only loans. Tr. 1293-94.

Sometime later, Duka's subordinate, Digney, learned that surveillance was using Table 1 constants. Tr. 475-76. He did not recall receiving any internal memorandum to that effect, however. Tr. 476. Likewise, Henschke, another of Duka's subordinates, was initially unaware that Table 1 constants would be used and also could not recall receiving a memorandum regarding the use of those constants. Tr. 1688-89. He came to understand that Table 1 constants were being used after seeing that usage in S&P's ratings model. Tr. 1688.

The criteria committee met in March 2010 to discuss proposed "enhancements" to the CMBS framework model. *See* Div. Ex. 48 at 2. Noting that S&P had seen "[s]ome new issuance requests . . . where the actual debt service was higher than that calculated with the [Table 1] constants," the committee decided that the rating model should calculate debt service using the higher of the debt service derived using the Table 1 constant or the actual debt service. *Id.* As Duka and Digney both explained, if the Table 1 constant is lower than the actual constant, using the Table 1 constant would not stress the loan. Tr. 477-78, 1434. The committee also decided "to calculate lost interest using the interest rate derived from the constant, or, if higher, the actual loan interest rate." Div. Ex. 48 at 2.

Notes from the meeting suggest that it was a criteria meeting. Div. Ex. 48. The committee's decision, however, was not published externally. Tr. 1301-02, 1464. This suggests the decision reached was an interpretation. Indeed, by Adelson's lights, it could not have been a criteria change because it was not published. *See* Tr. 283.

In June 2010, S&P published a criteria article announcing an update to its methodology for evaluating commercial real estate collateral used in CMBS transactions. Resp. Ex. 4 at 3. The charts in this article largely dealt with capitalization rates for various property types. In Appendix B, the article provided an example of how S&P would analyze hotel property cash flow. *Id.* at 34-37. The Appendix B example used an actual loan constant of 8.6% rather than the Table 1 loan constant for hotel properties, which was 10.0%. Tr. 166-69, 1304-05; Resp. Ex. 695F; *see* Joint Ex. 2 at 5.

Also in June, Duka and Thompson sent Diamond a monthly activity report for CMBS. Div. Ex. 51. In it, they noted that new issuance lost out on two ratings, one because of the terms of S&P's engagement letter and one because of S&P's credit enhancement level. *Id.* at 1; Tr. 1167-68. The latter transaction, issued by JP Morgan, was the first conduit/fusion transaction issued in over two years. Div. Ex.

51 at 1. Thompson and Duka also reported that new issuance had rated several non-conduit/fusion deals and lost out on rating three others. *Id.*

One week later, S&P published a commentary on the JP Morgan CMBS transaction it was not chosen to rate. *See* Div. Ex. 230. Two of Duka's subordinates were listed as analysts on the commentary and Duka was listed as the analytical manager. *Id.* at 10 (of paginated pages). S&P rated this transaction because it was the first conduit/fusion CMBS transaction issued since the criteria article was published. *Id.* at 1. The commentary stated that S&P believed it was important to inform the market of its views. *Id.* In the commentary, S&P explained that it would use its Table 1 "stressed constants" to evaluate a transaction. *Id.* at 5; Tr. 1216-17.

1.3. Switch to blended constants

1.3.1. August to December 2010

CMBS activity began to increase in the second half of 2010.[21] *See* Resp. Ex. 305. By late July and August, Duka anticipated that the issuance of new conduit/fusion transactions would increase and that CMBS's workload would increase along with it. Resp. Ex. 204 at 1; Resp. Ex. 210; *see* Tr. 1316-17, 1319-20. And due to the increase in CMBS activity and an anticipated further increase in the future, Duka received authority to increase the size of her staff from 6 to 11 analysts. *See* Resp. Ex. 211 at 4 (of paginated pages).

At the same time, CMBS analysts began to believe that use of Table 1 constants did not make sense. *See* Tr. 730-31. Indeed, as a general matter, the market viewed S&P's criteria as conservative. Tr. 654-55, 895-96. Digney testified that at some point while he was working in surveillance, it crossed his mind that actual constants should be used, given the results he was seeing. Tr. 478-79. He explained that almost all the loans CMBS rated were fixed rate loans. Tr. 437, 477. As a result, an economic downturn would not have changed the annual debt service. Tr. 476-77. This also explained why the criteria article did not call for stressing the numerator of the loan-to-value ratio. Tr. 476-77.

Digney recalled that at some point in the latter part of 2010 Henschke expressed to Digney the view that using the Table 1 constants "was not analytically appropriate."[22] Tr. 729-30. Henschke confirmed that he discussed this opinion with

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21 Although new issuance was not engaged to rate CMBS conduit/fusion transactions in 2010, it rated other transactions. *See* Tr. 1112.

22 Henschke started working at S&P in 2004. Tr. 1685. He moved to new issuance in 2005 and remained there until he left S&P in January 2011. Tr. 1685-86.

"probably almost everyone." Tr. 1699-1700. Thompson recalled that during the fall of 2010 both Henschke and Pollem raised concerns about whether it was analytically appropriate to use Table 1 constants to calculate the debt service coverage ratio for purposes of the term default test. Tr. 178.

For his part, Digney favored using actual constants. Tr. 731. According to Henschke, in the second half of 2010, analysts began to see that their models were producing "very high" subordination levels and were predicting that all loans would default during their terms. Tr. 1692-93. Given the low interest rate environment, the risk of term defaults was lower than the risk of defaults at maturity, when future interest rates could be higher. Tr. 1697; *see* Tr. 1711-12. Henschke thus thought that using Table 1 constants did not make sense.[23] Tr. 1698-99. Duka agreed with this perspective, explaining that market conditions—interest rates—in late 2010 changed such that using Table 1 constants caused S&P's predictions to diverge from the actual performance of the loans in transactions it rated. Tr. 1165-66. Henschke conceded that people at S&P believed that lowering credit enhancement levels would increase business. Tr. 1713-14.

In August 2010, S&P published an article, authored by Thompson, titled CMBS Framework Model. Div. Ex. 180; Tr. 85-86. Thompson testified that S&P used the framework model described in the article to rate CMBS transactions. Tr. 86-88. In the article, Thompson explained that "[t]he CMBS framework model incorporates the assumptions we set forth in our June 26, 2009, criteria update." Div. Ex. 180 at 4. He also explained that S&P's "loan constants by property type" were among the "primary inputs to the model." *Id.*

Evidence showed that the pace in new issuance had increased by August 2010. *See* Resp. Ex. 211. At this point, S&P was "rating a large share of" all single-borrower transactions. Tr. 1465. The increase left new issuance short on staff. *See* Resp. Ex. 210; Tr. 1319. In an activity report sent to Jacob and Osborne in that same month, Duka and Thompson reported that they were "continuing to run over capacity on the new issuance and surveillance fronts" and that their "most recent staffing model results both continue to show resource utilization in excess of 100%." Resp. Ex. 211 at 4 (of paginated pages).

Duka and Thompson also reported that they "continu[ed] to see market interest in new ratings Assignments." Resp. Ex. 211 at 1. They stated that it was "notable" that they were rating a JP Morgan conduit transaction in that S&P was

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[23] Henschke further testified that "we were already applying significant stress to the cash flows [for loan payments]. . . . So applying [that] significant stress . . . and then applying significant stress to [interest rates] caused all those term defaults which yielded subordination levels that were significantly higher than [the] archetypical pool." Tr. 1724.

"not asked to rate [JP Morgan's] [previous] transaction, partly for criteria reasons." *Id.* Jacob interpreted this reference to criteria reasons to mean that the issuer thought S&P's criteria were too conservative. Tr. 529 (discussing Div. Ex. 54, which is the same memorandum as in Resp. Ex. 211). Duka and Thompson also noted that "[a]ctivity continue[d] to increase," and described the transactions S&P had been engaged to rate. Resp. Ex. 211 at 3. They reported, however, that "due to the terms of" S&P's "new (revised) engagement letter," it had lost out on at least two ratings engagements and was at risk of losing another in a single-borrower transaction.[24] *Id.* S&P also lost out on another rating for reasons unrelated to criteria. *Id.*; *see* Tr. 581.[25] More generally, they reported that "[v]irtually every issuer ha[d] expressed concerns with [S&P's] terms and conditions," four issuers would neither sign nor show S&P transactions, and other issuers had signed but "expressed hesitation in doing so going forward." Resp. Ex. 211 at 2.

The following month, Thompson and Duka reported that over the preceding four to five months, S&P had lost at least seven ratings because issuers objected to the terms and conditions of S&P's engagement letter. Resp. Ex. 234 at 3 (of paginated pages). They also lost out on a transaction issued by Deutsche Bank because S&P's preliminary feedback was more conservative than that provided by Moody's and Fitch. Div. Ex. 56 at 1.

In early October, Jacob asked Osborne whether S&P had looked at a number of specific transactions. Resp. Ex. 245 at 2. Osborne forwarded the inquiry to Duka. *Id.* She and another person responded that S&P had lost out on rating three of the transactions because the issuers had concerns about S&P's terms and conditions. *Id.* at 1. S&P had not been engaged on a fourth—the aforementioned Deutsche Bank transaction—because its feedback was relatively more conservative than other agencies' feedback. *Id.* Duka was unsure why S&P was not engaged on a fifth but speculated that the reason could be S&P's criteria or S&P's terms and conditions or a combination of reasons. *Id.*

In early November 2010, Jacob forwarded Duka, Osborne, and Thompson an article that reported "new life" in the CMBS market and forecast $100 billion in issuances by 2013. Resp. Ex. 259 at 1. In forwarding the e-mail, Jacob said to Duka, "pls don't get a heart attack. Still 2 years away." *Id.* Among other things, Duka

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24 S&P was insisting that "issuers . . . take responsibility for the quality and accuracy of information about the deals and the underlying assets." Resp. Ex. 237 at 3. Some issuers opposed this requirement. *Id.*

25 At page 581, Jacob discussed a July activity report. Comparison of that report and the August report reveals that both reports discuss the same four missed or potentially missed transactions. *Compare* Resp. Ex. 198 at 4, *with* Resp. Ex. 211 at 3 (of paginated pages).

responded "if I'm going to get anxious this is a good . . . reason to do so and I'll take it." *Id.* She added that she was glad "we are going in 1 direction rather than the manic ups and downs we now see" and that the report was consistent with what she had already inferred. *Id.*

Two days later, S&P published another criteria article. Joint Ex. 5. Duka, Parisi, and Thompson were all listed on the first page of the article. *Id.* at 1. This article "refin[ed] the methodology [S&P] use[d] to rate U.S. conduit/fusion commercial mortgage-backed securities (CMBS) transactions." *Id.* at 3. The article contained the same Table 6 as in the June 2009 criteria article—an example using an actual constant rather than the constant listed in Table 1—and the same glossary definition of debt service coverage. *Compare id.* at 6, 16, 30, *with* Joint Ex. 2 at 5, 16, 30 *and* Tr. 108-09, 352, 1271-72, 1286.

A week later, on November 11, Osborne e-mailed Duka, Thompson, and two others, asking each to send Osborne "5 key accomplishments/challenges for each of" their teams. Div. Ex. 58 at 2. Among the five accomplishments Duka reported were that the volume of new issuances had been increasing and her team had "managed to stay ahead of it, while balancing [their] many other priorities." *Id.* at 1. Among the five challenges, Duka stated that "criteria, while better than in the past, still fails to consider the business (i.e. give sufficient notice or consider the infrastructure needed to implement changes) to potentially digest huge changes that could impact resources. Also, our position on [terms and conditions] has been a disadvantage." *Id.* She also said that a challenge was:

> More conservative criteria, particularly on conduit / fusion transactions and probably counterparty criteria (depending on where bank ratings migrate to). Could impact the business. May depend on investors and volume (i.e. the more volume, the more of an investor base that will be needed to buy....giving potentially more balance of power to investors than what exists today).

Id. (ellipsis in original). As to this latter point, Duka testified that investors have influence and if they want a particular rating agency to rate a transaction, they can use their influence. Tr. 1176. She also agreed that more conservative criteria could have affected S&P's business, in that being more conservative "may make it harder" to be retained to rate deals. Tr. 1176.

The next day, Duka told Jacob, Osborne, and Thompson of a report that Moody's had added seven analysts. Resp. Ex. 272. This meant that it had 42 analysts evenly spread between new issuance and surveillance. *Id.* Duka added that she only had 12 analysts, including herself. *Id.* Duka hoped to convince her superiors to hire more staff. Tr. 1333. Jacob recalled that the CMBS conduit/fusion market was seeing increased activity during this time. Tr. 599-600. Indeed, just past noon on a Sunday two days later, Duka responded to an inquiry from Jacob saying that she was busy and expected to continue to stay busy through the end of the year. Resp. Ex. 273.

Within a few days, on November 16, a CMBS researcher informed Duka, Thompson, and Jacob that most analysts had increased their forecast for CMBS activity in 2011 and some thought new issuance would reach $100 billion in 2012. Resp. Ex. 278. The next day, Duka e-mailed Osborne and Thompson to "update [them] . . . on the tidal wave that [she] expect[ed] to see come in either next week or the week after." Resp. Ex. 282 at 1. She reported that new issuance had been engaged to rate a new transaction and had "[f]irst feedback" that was due during the first two weeks of December on five transactions. *Id.*; *see* Tr. 1335.

By the first week of December, Duka and her staff were busy and getting busier. *See* Resp. Ex. 305. Having entered the last quarter of the year expecting to rate zero conduit/fusion transactions, new issuance rated one. *Id.*; Tr. 608. Duka expected it to rate three to four in the first quarter of 2011, partly due to the fact that all but one issuer—Goldman Sachs—had agreed to sign S&P's terms and conditions. Resp. Ex. 305; *see* Tr. 608-09. She also expected her team to be very busy with work associated with training new analysts and meeting with issuers and investors. Resp. Ex. 305.

On December 9, 2010, Henschke sent comments to Duka, Thompson, and others regarding a draft model quality review report.[26] Resp. Ex. 318; *see* Tr. 179-80. Three days later, on December 12, Duka responded to every recipient of the first e-mail, including Thompson, and stated that her comments and edits were included in an attached draft. Resp. Ex. 318 at 1; Tr. 180. In his original draft, Henschke said "we use the higher of the actual debt constant or the S&P debt constant." Resp. Ex. 318 at 6. Duka responded that "Henschke's starting to convince me that we should rethink this, as it does not have the intended result." *Id.* Duka elaborated during the hearing that what she meant by "this" was the use of Table 1 constants. Tr. 1375-76. She testified that Henschke's point was that Table 1

[26] Haixin Hu, a model quality review associate director two levels below Adelson, *see* Div. Ex. B-1, e-mailed Thompson on November 8, 2010, asking for "corrections and comments" to a draft report she was tasked to prepare regarding the model CMBS used to analyze credit enhancement levels for conduit/fusion CMBS transactions. *See* Resp. Ex. 334 at 3-4; Resp. Ex. 499 at 16-17, 22; Resp. Ex. 535 at 7. In part, Hu sought CMBS's input in order to correct any factual inaccuracies in her description of how CMBS rated transactions. *See* Resp. 334 at 3. Henschke's comments related to Hu's request. *See* Resp. Ex. 318 at 2 (stating that CMBS was responding to the report dated November 8, 2010).

constants did not accurately "reflect the credit risk of the underlying loans" and arbitrarily generated random results. Tr. 1375-77.

Meanwhile, Duka's team's workload continued to increase. On Friday, December 10, she e-mailed Osborne and Thompson to report that she had two deals she could "manage," but had received three more that day and would receive a fourth the following Monday. Resp. Ex. 316. As a result, she was "going to need help NOW." *Id.*; *see* Tr. 1339 ("I'm concerned that I don't have adequate staffing to complete the work . . . in the manner that I would like.").

The following Monday, December 13, Duka and Thompson sent Jacob and Osborne an activity report noting a "significant increase in rating activity, since the revised terms & conditions have been distributed." Div. Ex. 61 at 2 (of paginated pages); *see also* Resp. Ex. 322 (discussing an employee's desire to use a vacation day and the increased work load). They reported losing out on rating three deals, two "due to criteria" and one due to the issuer's refusal to sign S&P's terms and conditions.[27] Div. Ex. 61 at 2. Thompson testified that losing out on a rating "due to criteria" meant that S&P's credit enhancement levels were high relative to other agencies. Tr. 75-76. Jacob said that issuers were likely not pleased with S&P's criteria but said that "in all fairness," credit enhancement is only one part of criteria and that it was possible there were other aspects that the issuers did not like. Tr. 530. Duka and Thompson also reported that new issuance was in the process of rating eight transactions and had met or spoken with "multiple issuers" as "[a]ctivity continue[d] to increase." Div. Ex. 61 at 4. Finally, they predicted a significant growth in 2011 in CMBS new issuance, primarily in conduit/fusion transactions. *Id.* at 6. They anticipated the need to hire additional staff and noted that other rating agencies had begun doing so. *Id.*

During the first week of January 2011, Duka learned that it was likely that S&P's ratings engagements would increase even more than anticipated. First, Freddie Mac announced that in 2011, it planned to double its CMBS issuance. *See* Resp. Ex. 343 at 2; Tr. 613. Second, Goldman Sachs, the last holdout among issuers that refused to sign S&P's engagement letter, had relented and agreed to sign. Resp. Ex. 344; *see also* Resp. Ex. 360. And three weeks later, new issuance was so busy, Duka was considering the need to "turn[] deals away."[28] Resp. Ex. 372. By February, Duka reported that new issuance could only barely keep up with the pace of work, and even doing that required using personnel from surveillance. Resp. Ex.

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27 According to Jacob, after December 14, 2010, the leading cause for lost business was S&P's criteria. Tr. 663.

28 In mid-February, Duka canceled a deal because she "could not get comfortable" with the loans in it. Resp. Ex. 415; Tr. 618.

400 at 1. She did not believe they could continue without adversely affecting surveillance and explained that she was concerned about a drop in morale.[29] *Id.*

1.3.2. Duka and Thompson meet with Parisi

As noted, during the relevant time, Parisi was the chief credit officer for structured finance in the criteria group. Tr. 1483. And he temporarily served as the CMBS criteria officer from August to December 2010. Tr. 1491. He holds a master's in statistics and a doctorate in management of engineering and technology. Tr. 1482. Parisi worked for S&P from 1985 to 2015. Tr. 1482, 1494. He replaced Tom Gillis as the chief credit officer for structured finance around October 2009. Tr. 1483, 1485. In that role, he reported to Adelson, who was the chief credit officer for S&P. Tr. 1488. Parisi oversaw five criteria officers assigned to different practice areas and was responsible for the development of criteria for S&P's four structured finance divisions. Tr. 1487. In 2016, he settled allegations against him with the Commission relating to an S&P criteria article that he drafted in 2012. *See Francis Parisi*, Securities Act Release No. 10050, 2016 WL 878137 (Mar. 7, 2016). The Commission found Parisi liable for willfully violating Section 17(a)(2) of the Securities Act, ordered him to cease and desist from future violations of Section 17(a), fined him, and barred him from associating with any nationally recognized statistical rating organization. *Id.* at *5.

Duka and Thompson met with Parisi on December 14, 2010, to discuss CMBS's use of constants. Tr. 89, 1392. Although what transpired during this meeting is significant to the Division's case, the meeting's participants had varying recollections of it.

Parisi recalled that Duka and one other person attended the meeting. Tr. 1511. He could not recall how the meeting was initiated and could not remember how long it lasted. Tr. 1511-12. According to Parisi, Duka sought his analytical opinion and asked about "loan constants for a particular issuance." Tr. 1513. He testified that she proposed to use the average "of the published constants and the then-current market rates." Tr. 1513. Averaging the Table 1 and actual constants in this manner was referred to as a 50/50 blend or a blended constant. *See* Tr. 1133-35.

Parisi recalled that Duka proposed this change in relation to a Freddie Mac transaction. Tr. 1514-15. This mattered to Parisi because of Freddie Mac's relatively superior "underwriting standards, loan quality standards, sole servicer guidelines,"

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[29] In contrast to the foregoing documentary evidence, analyst Brian Snow testified that CMBS was not very busy in February 2011. Tr. 1772. He had previously said that he was engaged in "busy work" during this time. Tr. 1773. Given the contrary documentary evidence, I do not credit Snow's recollection on this point.

and generally "better quality" loans. Tr. 1514-15. He thought it would be reasonable to make the proposed adjustment (*i.e.*, using less stressed constants) for one particular transaction with these higher quality loans, rather than "across-the-board." Tr. 1515-16; *see* Tr. 1559 ("it made sense"). On cross-examination, Parisi conceded that it would be logical to apply this interpretation to other Freddie Mac transactions, given the quality of the collateral in those transactions. Tr. 1575-76.

Duka, by contrast, recalled that the Freddie Mac discussion occurred at a different meeting. Tr. 1384-87. Parisi would later concede this possibility. Tr. 1587-88. Duka testified that she did not recall during the Freddie Mac meeting Parisi limiting the number of Freddie Mac deals to which the interpretation could apply. Tr. 1391. Parisi, however, testified that if the discussion had been about more than a single transaction, the proposal would have represented a change in criteria that would have triggered the formal criteria change process. Tr. 1514. He did not understand Duka to be suggesting a broader change. Tr. 1516-17. Parisi testified that he was not asked to approve anything and did not do so. Tr. 1516.

On the other hand, Parisi testified that he told Duka and Thompson that if they made a change, they "should document it." Tr. 1517. Parisi explained that, to him, "document[ing] it" meant including an explanation in the RAMP and the presale. Tr. 1517-18; *see* Tr. 1589. He did not recall whether Duka responded to his suggestion. Tr. 1518. Parisi also could not remember whether Duka gave him any written materials. Tr. 1518-19.

Duka testified that, at the meeting on December 14 and separate from the aforementioned meeting concerning Freddie Mac transactions, she visited Parisi because it was his job to interpret criteria.[30] Tr. 1138. She said they talked about S&P's then-current ratings methodology and she explained why she thought it did not make sense. Tr. 1140. Contrary to Parisi, Duka testified that she showed Parisi a spreadsheet with three columns: actual constant, stressed (Table 1) constant, and 50/50 blend. Tr. 1158, 1379-80; *see* Resp. Ex. 670C, sheet 2; Tr. 1183 (testifying that she would necessarily have changed the model before meeting with Parisi in order to show him data). To corroborate this assertion, Duka offered a spreadsheet created on December 13, 2010, that she obtained by subpoena from the Commission. Tr. 1379-81; Resp. Ex. 670C. The spreadsheet contained a sheet with the three columns Duka had described and information derived from a deal called Wells 2011-C2; it did not relate to any Freddie Mac transactions. Tr. 1380; Resp. Ex. 670C, sheet 2. The spreadsheet was of the type Duka recalled showing Parisi at the December 14 meeting, though Duka did not actually recall showing Parisi the specific spreadsheet in question. Tr. 1379, 1441. Although unsure, Duka thought Henschke prepared the spreadsheet. Tr. 1441-42. Henschke confirmed that either

30 Duka was not alone in this view. Jacob agreed that Parisi could interpret criteria. Tr. 651-52.

he prepared the spreadsheet or one of the modelers in new issuance did. Tr. 1702. For his part, Parisi did not remember seeing the spreadsheet.[31] Tr. 1519.

On examining the spreadsheet during the hearing, Parisi said that it contained the type of information he would expect would be used to show the impact of the change Duka raised. Tr. 1520-21. From the spreadsheet alone, he could not tell whether the information it contained reflected an across-the-board criteria change. Tr. 1521-22. He believed, however, that use of a blended constant would stress the loan depicted in the spreadsheet because the blended constant was higher than the actual constant. Tr. 1567.

According to Duka, Parisi agreed that it did not make sense to use Table 1 constants and that they "could amend the previous interpretations." Tr. 1140; *see* Tr. 1382. Duka also testified that Parisi told her and Thompson to document the change in interpretation in presales and RAMPS. Tr. 1140. She agreed to do so, but testified that she did not think she was promising to do anything that would not have happened anyway, given that analysts must disclose the methodology that goes into a rating. Tr. 1142, 1473-74. Duka disputed that Parisi said the change would apply only to one transaction. Tr. 1140-41. She said that applying the change only to a single transaction would not make sense from the perspective of "comparability and consistency." Tr. 1140-41; *see* Tr. 1142. She opined that the change to a blended constant was an interpretation, *i.e.*, a change that could occur without the need to resort to the criteria change process. Tr. 1155. Duka viewed the switch to using blended constants as an interpretation because of how the changes in July 2009 and March 2010 were handled. Tr. 1142, 1383; *see* Tr. 1155. She said Parisi made the decision and determined that the issue did not need to be escalated. Tr. 1138.

Duka testified that she did not document the meeting with Parisi because it was Parisi's job as criteria officer at that time to do so. *See* Tr. 1139, 1159. Thompson agreed that taking notes would have been Parisi's responsibility as criteria officer. *See* Tr. 187. Neither Duka nor Thompson raised with Adelson the issue of the use of blended constants. Tr. 95, 186-88, 1159.

Henschke recalled learning from Duka after her meeting with Parisi that new issuance would use blended constants. Tr. 1702. Henschke did not recall Duka

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[31] Through its questioning, the Division suggested that although Duka testified during the hearing that the change from using Table 1 constants to blended constants took place after the meeting with Parisi, Tr. 1136, during her investigative testimony, Duka was unsure and said it was "possible it happened before." Div. Ex. 338 at 581. But other than changing the model before meeting with Parisi in order to show him data, there was no evidence that the change actually occurred before the meeting with Parisi. Tr. 1183.

issuing any e-mail or memo explaining the change. Tr. 1725-26. Snow did not remember Duka or Pollem telling him that Duka had agreed to disclose the use of blended constants in presales or RAMPs. Tr. 1783-84. Nor did Snow recall anyone telling him that he needed to disclose the use of blended constants in the presales or RAMPs. Tr. 1784.

Thompson remembered that he, Duka, and Parisi were at the December 2010 meeting. Tr. 89. He did not recall anyone taking notes. Tr. 187. According to Thompson, the meeting did not last long and chiefly involved a discussion regarding whether it might be appropriate to "use different constants" or "alternative methods or assumptions" and under what circumstances that might be the case. Tr. 90-91. He did not recall a specific proposal being presented and instead thought the discussion involved "a general dialogue about the framework." Tr. 91. He thought the discussion revolved around the appropriateness of the then-current use of constants "given the environment." Tr. 93. Thompson did not recall any analysis or materials being presented to Parisi. Tr. 91-93.

Thompson came away from the meeting thinking that Parisi "was open to using different constants" if that use was "documented." Tr. 93. To Thompson, documenting something meant putting it in a RAMP and presale. Tr. 93-94. Thompson also recalled that Parisi indicated "there was room for analysts' judgment in regard to the work or the assumptions as the analysis was being conducted." Tr. 93.

Thompson testified inconsistently about Parisi's opinion regarding the continued use of blended constants. He initially recalled that Parisi was flexible and that his flexibility related to specific loans or transactions; it was not "programmatic." Tr. 94. On cross-examination, however, Thompson was asked whether "Parisi indicate[d] . . . that analysts' discretion *could always be had to potentially average constants*." Tr. 183 (emphasis added). Thompson responded, "My recollection was he said that analysts could apply their judgment, so *yes*." Tr. 184 (emphasis added). Generally, Thompson thought there was room for analysts to exercise judgment and the meeting simply provided "clarity around where those guidelines and boundaries were." Tr. 184-85.

Thompson testified that he thought the issue should have been "socialized" with Adelson or the quality group to make sure everyone was on the same page. Tr. 95-96, 192. He did not, however, think there was a requirement that it be raised with other people. Tr. 96. Thompson's alleged belief that it should be raised with others was based on the fact that "there was a lot of sensitivity around the methodology" and the fact that Adelson "was a very opinionated person with a strong personality." Tr. 96. He professed to being concerned that Parisi might not raise the issue with Adelson. Tr. 186. Although Duka did not recall Thompson saying the issue should be elevated, Tr. 1142, Thompson testified that he briefly discussed with Duka the possibility of "elevating" the issue, Tr. 96. In his remaining three weeks with S&P, however, Thompson did not raise the issue with Adelson or the quality group. *See* Tr. 39, 95-96, 186-88, 191, 1478-79.

Indeed, Thompson was very quickly presented with an opportunity to "socialize" the issue. On December 15, 2010, Digney forwarded more comments about the draft model quality review report discussed the previous week—the draft about which Hu sought comments on November 8. Div. Ex. 70; *see* Resp. Ex. 318; Resp. Ex. 499 at 16-17; *supra* note 266. In the attached comments, Henschke stated that S&P could "use an alternate debt constant" *because* "the criteria doesn't stipulate that we have to use loan constants listed."[32] Div. Ex. 70 at 6. He explained that he referred only to the use of the "alternate debt constant" (*i.e.*, the blended constant) rather than specifying that the higher of the blended constant or actual constant would be used because he "was being vague . . . in case we wanted to change [the language] in the future" if necessary. Tr. 1706.

The next day, December 16, 2010, Thompson responded. *See* Div. Ex. 71. He suggested including the following emphasized language: "Further, we may use an alternate debt constant *in certain circumstances since the criteria doesn't stipulate that we have to use loan constants listed. If we do, we would document it [in] the RAMP.*" *Id.* at 3, 6, 10; Tr. 198-200.

On December 17, 2010, Thompson e-mailed Hu, responding to the request for corrections and input she sent on November 8. Resp. Ex. 334. Thompson was responding on behalf of the CMBS group and copied Osborne, Duka, and other personnel in new issuance and surveillance. Resp. Ex. 334 at 1; Tr. 188-89; *see* Tr. 732 (affirming that Thompson responded after "internal correspondence within the CMBS group as to how to respond to Haixin Hu"). He explained to Hu that:

> the loan constants were not derived based on the archetypical pool, they were determined after deliberation in a criteria committee. Further, we may use an alternate debt constant in certain circumstances *since the criteria doesn't stipulate that we have to use loan constants listed*. If we do, we would document it in the RAMP.

Resp. Ex. 334 at 2 (emphasis added). There is no evidence that Osborne or any other recipient of the e-mail in CMBS objected to this statement, *see* Tr. 733-34, which,

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[32] The e-mail was sent by Digney but indicated that the edits came from multiple individuals. Div. Ex. 70 at 1. The comment in question, however, is attributable to Henschke. *See* Tr. 1706 (Henschke inquiring "Are you asking me why *I didn't say* [the higher of the actual or the 50/50 blended constant] versus the [alternative debt constant]" (emphasis added)).

three days after the meeting with Parisi, indicated on behalf of the CMBS group that the use of "listed" (*i.e.*, Table 1) constants was not required.

On direct examination, Parisi denied that he knew during the first few months of 2011 that new issuance was using blended constants. Tr. 1567. By the end of his cross-examination, it was apparent that his recollection of events was not reliable. First, he conceded that having been shown evidence during his testimony, he could no longer say that he did not have a second meeting with Duka, *i.e.*, a meeting focused on Freddie Mac transactions separate from the meeting on December 14. Tr. 1587-88. Second, he generally conceded that although he knew "what [he] recall[ed]" about the December 14 meeting, he could not refute evidence contrary to his testimony about that meeting. Tr. 1587-88.

In fact, evidence showed that Parisi's recollection was mistaken, and that he knew about the use of blended constants in the first half of 2011. On April 20, 2011, Digney sent an e-mail to a number of people, including Duka and Geramian, who became the CMBS criteria officer in December 2010 and worked under Parisi. Resp. Ex. 473 at 1-2; *see* Div. Ex. B-1; Tr. 1490. In the e-mail, Digney noted, among other issues, that "[w]e are currently using a 50/50 blend of actual loan constants and the stressed [*i.e.*, Table 1] loan constants set forth in the criteria." Resp. Ex. 473 at 2; *see* Tr. 787. Concerned that this approach might "overstat[e] term defaults," he proposed "us[ing] the actual loan constants for [the] term default tests."[33] Resp. Ex. 473 at 2. Duka replied to Geramian, Digney, and two others to clarify to Geramian who in CMBS was responsible for various issues Digney raised. *Id.* at 1. Geramian responded simply by saying "thanks"; there is no evidence that he voiced any concerns about Digney's statement regarding the then-current use of blended constants. *See id.*; Tr. 789.

Digney personally provided Geramian with a similar proposal a month later on May 19, 2011, which he also e-mailed to Geramian the next day. Resp. Ex. 514 at 1, 3; Tr. 790-91. The proposal stated, under the heading "Stressed Loan Constants," that "*[w]e are currently using a 50/50 blend of actual loan constants and the stressed loan constants set forth in Table 1 of the criteria* (unless the actual loan constant is higher), which may be overstating term defaults." Resp. Ex. 514 at 3 (emphasis added). The document then proposed "us[ing] the actual loan constants for our term default tests, since those are in fact the loan constants in place during the loan term," and, in conjunction with that less conservative change, making the "maturity default tests" more conservative. *Id.* On May 21, 2011, Geramian

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33 Digney explained during the hearing that while it might make sense to stress a loan when it matures because the interest-rate environment at maturity is unknowable, it does not make sense to stress a loan during the term because its interest rate will not change. Tr. 787-89. As noted above, Henschke expressed a similar view at the hearing. Tr. 1697-99; *see* Tr. 1711-12.

responded, *copying Parisi*, who was the only recipient of the e-mail other than Digney and Duka. Resp. Ex. 517. The e-mail reattached Digney's aforementioned proposal, and among other things, referenced the "Stressed Loan Constants" issue and inquired about the proposed maturity default tests. *Id.* at 1. Parisi testified that he did not recall receiving the e-mails. Tr. 1523-24. But on May 21, 2011, he responded to the e-mail chain. Resp. Ex. 518 at 1. And though Parisi was skeptical of the proposed changes—suggesting he reviewed the entire document—he did not take issue with the document's factual statement that blended constants were "currently" being used. Resp. Ex. 514 at 3; Resp. Ex. 518 at 1; *see* Tr. 1571-72. Moreover, Parisi's handwritten notes concerning this e-mail chain are consistent with him being aware of new issuance's use of the blended constant. *See* Tr. 1572-75; Resp. Ex. 657 at 7; *see also* Resp. Ex. 517 at 1. He raised no objection to their then-current use, however. Tr. 793-94; Resp. Ex. 518 at 1.

Parisi's failure to object shows that he was aware of new issuance's use of blended constants. On these facts, and for the reasons discussed below in Section 2.1.1., I conclude that Parisi approved and became aware of new issuance's use of blended constants on December 14, 2010.

1.4. Model Quality Review's 2011 report for the CMBS framework model

Meanwhile, in January 2011, Hu circulated a revised draft of the model quality review report regarding the CMBS framework model.[34] *See* Resp. Ex. 480 at 4. She e-mailed questions to Duka, copying her subordinates in new issuance. *Id.* With regard to a question about constants, Duka responded in March that new issuance "consider[ed] both the constants in Table 6[35] and the actual constants."[36]

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34 Also in January, Duka spoke with Susan Barnes, a quality officer under Bukspan, about CMBS's use of constants. Div. Ex. 73. In a follow-up e-mail, Duka explained that for a listed group of transactions, new issuance "provided feedback which incorporated looking at both the actual constant and S&P constants." *Id.* She offered to send Barnes the subsequent presales, when they were issued, but Barnes said she would locate "the analysis" herself in a repository S&P maintained. *Id.*; *see* Tr. 1248-49. Duka testified that she assumed this meant she did not need to send the presales to Barnes. Tr. 1248-49. There is no evidence Barnes needed Duka's help or permission to access the presales. As a result, there is no reason to dispute Duka's assumption.

35 Confusingly, although Duka referenced "Table 6," she was referring to the constants in Table 1 of the criteria article. Tr. 1188-89. The Table 6 she referenced is found in the model quality review report and contains the constants found in Table 1 of the criteria article (in addition to constants for property types not found in Table 1); this Table 6 is *not* the same Table 6 found in the criteria article,

Id. at 3. Duka subsequently added that "New Issuance would use the actual (if higher) but look at both if the actual constant is lower than the Table 6."[37] *Id.*

Hu responded with changes based on Duka's input. Resp. Ex. 480 at 2. She also explained that she had added language: "The 'loan constants' used in the Model is the higher of the actual loan constants and those depicted in Table 6." Resp. Ex. 480 at 2. At first, Digney testified that he thought this response indicated that Hu did not fully understand Duka's e-mails, as it suggested new issuance was using criteria constants (*i.e.*, Table 1/"Table 6" constants) rather than blended constants as Duka had described. *See* Tr. 736-37. Later, he testified that it seemed likely that Hu "was looking at a version of a model that had the formula that took the higher of the actual or the criteria constants," suggesting that the model Hu possessed differed from the one used by new issuance. Tr. 808-09. But Digney only came to this realization in December 2016, when Division counsel questioned Digney about specific portions of Hu's e-mail interaction with CMBS personnel. *See* Tr. 806-09. Digney did not recall that Hu ever asked for a copy of the actual model new issuance used "that used the blended constant." Tr. 832-33.

In any event, after receiving Hu's e-mail, Duka e-mailed Digney and Ramkhelawan with a suggested response. Resp. Ex. 480 at 1. She suggested saying that new issuance "consider[ed] both the actual and the stressed constants . . . and may not necessarily default to the lower of the 2 in all situations. My prior email explains what we do and why." *Id.* Before sending the proposed response to Hu, Duka told Digney and Ramkhelawan "I just want to make sure I am explaining this right" and asked whether they "[c]ould . . . look at [her] responses and . . . meet for ½ hour and get this off my desk?" *Id.* Both responded that her description appeared correct. *Id.* Duka responded in the suggested fashion on April 27, 2011. *See* Resp. Ex. 479 at 1.

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discussed in section 1.2.1 and 1.3.1 of this initial decision. *Compare* Joint Ex. 2 at 5, 16, *with* Resp. Ex. 499 at 31.

[36] Gregory Ramkhelawan, a surveillance analyst, indicated that, unlike new issuance, surveillance generally used "pre-defined stress constants," *i.e.*, Table 1 constants, only if they were higher than the actual constants. Resp. Ex. 480 at 3; *see* Tr. 1428. Duka also understood this to be surveillance's practice at the time. *See* Resp. Ex. 480 at 3-4.

[37] This is consistent with Duka's hearing testimony that new issuance would generally use the higher of the actual or blended constant, Tr. 1133, and, for reasons already explained Duka's reference to "the Table 6" refers to Table 1 constants.

Hu forwarded Duka a draft model quality review report for the CMBS framework model on May 2, 2011. *See* Resp. Ex. 499. The draft provided that:

> The loan constants are described in Table 1 'Archetypical CMBS Conduit/Fusion Pool' of the Criteria [l]. The "loan constants" used in the Model is a combination of the actual loan constants and those depicted in [a table on the following page].
>
> We notice that the Model makes additional assumptions for property types not specified in the Criteria [l].

Id. at 30. The following page contained the "Table 6," which listed the same loan constants for the same property types as found in Table 1 of the criteria article, and also loan constants for property types not listed in Table 1 of the criteria article. *Id.* at 31; Joint Ex. 2 at 5; Tr. 742. S&P never published anything explaining how it arrived at the constants for the property types not listed in Table 1. Tr. 743. Digney testified that although the above-quoted language informed the reader that S&P used a "combination" of actual and stressed constants, an outsider would not know the combination was a "50/50 blend." Tr. 813.

The block-quoted language above was incorporated in the final version of the model quality review report for the CMBS framework model, issued in June 2011. *See* Resp. Ex. 535 at 18; Tr. 747. Geramian, as a criteria officer, approved this report. Resp. Ex. 535 at 12. Hu's supervisor, Martin Goldberg, sent the framework to a variety of recipients, including Duka, Osborne, Jacob, Milano, Bukspan, and Adelson. *Id.* at 1. There is no evidence that any recipient objected to the language contained in the framework. Tr. 747-48.

1.5. S&P issues presales for eight transactions in 2011

From February to July 2011, S&P issued the following eight presales on the following dates:

- Morgan Stanley Capital I Trust, 2011-C1 (February 4, 2011), Joint Ex. 22;
- FREMF 2011-K701 Mortgage Trust (February 15, 2011), Joint Ex. 30;[38]

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[38] Transactions with the designation "FREMF" involve loans sold and guaranteed by Freddie Mac. *See* Joint Ex. 30 at 4; Joint Ex. 46 at 4; Joint Ex. 53 at 4; Joint Ex. 77 at 4.

- J.P. Morgan Chase Commercial Mortgage Securities Trust 2011-C3 (February 18, 2011), Joint Ex. 37;[39]

- FREMF 2011-K11 Mortgage Trust (March 15, 2011), Joint Ex. 46;

- FREMF 2011-K13 Mortgage Trust (May 9, 2011), Joint Ex. 53;

- J.P. Morgan Chase Commercial Mortgage Securities Trust 2011-C4 (May 17, 2011), Joint Ex. 60;

- GS Mortgage Securities Trust 2011-GC4 (July 12, 2011), Joint Ex. 68;[40] and

- FREMF 2011-K14 Mortgage Trust (July 18, 2011), Joint Ex. 77.

All of these transactions were rated, and their credit enhancement levels determined, using debt service coverage ratios derived from blended constants. Tr. 766-69, 783-87, 830, 1191, 1612-17; *see* Answer at 21-22. Yet, the presales and RAMPS for these transactions indicated that the debt service coverage ratios were derived from Table 1 constants, which are more conservative. Tr. 1233-36 (Duka conceding this point); Div. Proposed Findings Nos. 53-54, 62 (citing and excerpting relevant portions of presales and RAMPs).

As detailed below, at the hearing there was testimony regarding general practices for the RAMPs and presales, as well as testimony concerning a number of specific transactions. As to this latter category, such evidence is illustrative for purposes of all eight transactions.

The preliminary feedback for the Morgan Stanley deal provided statistics that were generated using a blended constant. Tr. 1217-19; Joint Ex. 24. S&P reported an S&P trust debt service coverage of 1.33x and an S&P weighted average debt constant of 7.62%. Joint Ex. 24 at 5.

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39 The parties refer to the two J.P. Morgan Chase transactions relevant to this matter using the issuer's initials, JPMCC.

40 The GS in the name of this transaction refers to Goldman Sachs. *See* Joint Ex. 68 at 4, 7. The parties refer to this transaction as "the Goldman deal."

The RAMP for the Morgan Stanley transaction listed Brian Snow as the primary analyst.[41] Joint Ex. 23 at 1. It listed a debt service coverage of 1.20x and a weighted average debt service constant of 8.46%, figures that, unlike the figures in the preliminary feedback, were based on Table 1 constants rather than blended constants. *Id.* at 6; Resp. Ex. 24 at 5; Tr. 1219-20, 1231-32. The credit enhancement levels in the RAMP, however, were based on a debt service coverage using a blended constant, not a Table 1 constant. Tr. 1245. Duka, who was a member of the rating committee for this deal, Joint Ex. 23 at 3, agreed that the RAMP did not disclose use of blended constants, contrary to her agreement with Parisi to document the change in the RAMP, Tr. 1232. She testified, however, that the rating committee chair was responsible for ensuring that the RAMP reflected what was discussed by the committee. Tr. 1400. And the assigned analysts were responsible for preparing the analysis reflected in the RAMP. Tr. 1400-01.

The later presale, similar to the RAMP, reported the use of Table 1 constants rather than blended constants yet provided credit enhancement levels based on blended constants. In the document—which listed Snow as the primary analyst and Pollem as the secondary—S&P reported using an 8.46% loan constant to arrive at a debt service coverage of 1.2x; this 8.46% constant was the higher of the actual or Table 1 constant. Tr. 1219-21; *see* Joint Ex. 22 at 1, 5. The presale also stated that "Standard & Poor's [debt service coverages] range from 0.94x to 1.57x and are based on stressed loan constants ranging from 8.25% to 10.00%, depending on the property type." Joint Ex. 22 at 5. But as Duka testified, the credit enhancement level was calculated using a blended constant. Tr. 1222. She further testified that, at the time, she did not notice the discrepancy between the preliminary feedback and the presale, and conceded that the numbers in the presale should have matched those in the preliminary feedback, which was initially provided to the issuer. Tr. 1221-22.

The presales for the eight relevant transactions were prepared by a primary analyst. In general at the time, the primary analyst assigned to prepare a presale was responsible for most of the work to organize and write the document. Tr. 764. The primary received assistance from other analysts underwriting and analyzing particular loans. Tr. 764. Once a draft presale was assembled, "a number of . . . folks" reviewed it, including the analytical manager and possibly the legal department. Tr. 765. Digney or Pollem would typically serve as the secondary analyst, "overseeing the process and reviewing" the presale. Tr. 765.

Additionally, various tables in the presale contained figures based on Table 1 constants despite the fact that blended constants were being used. Tr. 1225-27, 1799; Joint Ex. 22 at 21, 23. Duka admitted that the presale did not "specifically

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[41] Snow worked at S&P from 2004 to 2014. Tr. 1736. During the relevant timeframe, he reported to Pollem, who reported to Duka. Tr. 1740.

disclose . . . the weighting between the constants" or the use of "a 50/50 blend." Tr. 1227, 1231. She asserted, however, that the presale "disclosed in the rating methodology section that" S&P "consider[ed] both the Table 1 constant and an actual constant." Tr. 1227. To support this assertion, Duka pointed to the following language in the presale:

> In determining a loan's DSC, Standard & Poor's will consider both the loan's actual debt constant and a stressed constant based on property type as further detailed in our conduit/fusion criteria.

Joint Ex. 22 at 18; Tr. 1228. Evidence presented showed that Pollem proposed this language to Duka on February 2, 2011. *See* Resp. Ex. 387 at 2; Tr. 1392-93.

Duka testified that she approved Pollem's proposed language. Tr. 1230, 1393. She asserted that the language was intended to describe S&P's "general methodology." Tr. 1394. She thought it best to describe the matter in a general way so as to avoid having to change the disclosure for each transaction. Tr. 1394. Duka conceded that "the totality of the disclosure [in the presale] could have been better." Tr. 1230. Duka denied trying to mislead any reader of the RAMPs or presales. Tr. 1250. After it was published, the presale for the Morgan Stanley transaction was distributed internally on February 10 to over 30 people, including Osborne and Jacob.[42] *See* Resp. Ex. 405.

Snow said that the language to which Duka pointed implicitly conveyed that an actual constant would be used during the term of the loan because that is when the actual constant is relevant. Tr. 1745. Snow asserted that a stressed constant, by contrast, is a hypothetical construct that is relevant for a balloon default analysis. Tr. 1745.

With respect to transactions rated with blended constants, Snow opined that it would not have been helpful to the reader to see data in a presale pertaining to

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42 The following week, on February 15, 2011, Snow proposed to Duka and Pollem that presales going forward include "2 DSC tables: 1 with actual constants; and 1 with S&P constants." Resp. Ex. 419. Duka testified that "[w]e took Brian Snow's recommendation." Tr. 1403. The subsequent presales, issued after February 2011, do contain these separate tables. Joint Ex. 46 at 24-26 (Tables 17 and 20); Joint Ex. 53 at 23-25 (Tables 17 and 20); Joint Ex. 60 at 22-23 (Tables 17 and 18); Joint Ex. 68 at 22-23 (Tables 17 and 18); Joint Ex. 77 at 25-26 (Tables 17 and 20). However, including separate tables of actual constants and Table 1 constants did not communicate that the two were blended for rating transactions—indeed, as noted below, individuals in new issuance were still considering in July 2011 disclosing the use of blended constants. *See* Div. Ex. 103.

blended constants. Tr. 1793-94. When asked why, he responded that as an analyst, he was supposed to do what he thought was "most reasonable in [his] professional judgment." Tr. 1794. He did not think those statistics would help the reader. Tr. 1795. Snow explained:

> If we wanted -- if we thought it was important to put that statistic out there, we could have done that.
> But, you know, presales are cranked out at a certain rate, and it's good to keep things simple. This is simple. That's hard to mess up.
> You'd be more consistent with these statistics. It's easier for the analyst. You're less likely to have mistakes.

Tr. 1796. Nonetheless, if Duka or Pollem had told Snow to disclose the use of blended constants in the presales, he would have complied with that directive. Tr. 1799.

Snow denied that he tried to mislead anyone with regard to the debt service coverage ratio described in the presale or how the ratio was calculated. Tr. 1760. When he was asked about the fact that the presales stated a debt service coverage ratio derived from Table 1 constants, whereas the model used blended constants, Snow said that he could not say whether he would have noticed the discrepancy. Tr. 1761. Nor could he say whether he or a more junior analyst input the figures in the presales. Tr. 1762.

No evidence was presented regarding what responsibilities S&P assigned Duka, as the person in charge of new issuance, with respect to the content of presales. Duka described her role in reviewing presales as largely editorial in nature. Tr. 1395-96. She did not reconcile the numbers and thus did not see that the presales represented that Table 1 constants were being used in relation to debt service coverage. Tr. 1395, 1397. Duka instead tried to ensure that the presales were uniform in appearance and style so that they appeared as though they were all written by the same person. Tr. 1395-96; 1470. She did not read the presales cover to cover. Tr. 1464.

On May 10, new issuance analyst Lucienne Fisher sent a final feedback e-mail to the issuer of JPMCC 2011-C4, the sixth of the eight transactions noted above. *See* Joint Ex. 62; Tr. 448-49 (despite referring to "preliminary feedback," e-mail was for final feedback for preliminary ratings). This feedback used a blended constant to calculate credit enhancement levels, the S&P weighted average debt constant, and the BBB-level trust debt service coverage ratio.[43] Tr. 449-50; *see* Joint

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[43] A pool-level weighted debt service constant is not used to derive credit enhancement levels and is instead simply a summary statistic. Tr. 829.

Ex. 62 at 3-4. In both the RAMP and the presale, however, S&P calculated the debt service coverage ratio using the Table 1 constants. Tr. 766-67, 773; Joint Ex. 60 at 5; Joint Ex. 61 at 6 (of paginated pages). Fisher was listed as the primary analyst and Digney as the secondary contact on the presale. Joint Ex. 60 at 1. On the RAMP, Fisher was listed as the primary analyst and Digney as the chair and backup analyst. Joint Ex. 61 at 1, 5. Digney denied that he or anyone else tried to mislead any reader of the presale, but admitted that "the methodology used to calculate the [debt service coverage ratio for actually rating the transaction] should have been calculated in the RAMPs." Tr. 767, 823. He also denied that Duka told anyone to report in feedback debt service coverage ratios derived from blended constants but to not use that information in the presale. Tr. 769.

Digney did not recall whether use of blended constants was discussed during the rating committee meeting for JPMCC 2011-C4. Tr. 772-73. He was under the impression, however, that every member of the committee knew that blended constants were used.[44] Tr. 773; *see* Tr. 437-38 (testifying that by March 2011 "it was something that was just sort of I guess universally known"). In this regard, Duka said that the model relating to credit enhancements was displayed on a screen during rating committee meetings. Tr. 1466. Snow confirmed this. *See* Tr. 1792 (testifying that if new issuance was using blended constants and he "was in the room when" the rating committee "reviewed models," he would have known about the use of blended constants). Digney opined that the RAMP included calculations based on Table 1 constants because analysts relied on "cutting and pasting." Tr. 773. He agreed that "sloppiness" accounted for the fact that Table 1 constants rather than blended constants were used in the RAMP. Tr. 774. Digney further explained that, for the presales, analysts tended to use previous transactions as a template. Tr. 765, 818, 820. Snow confirmed this testimony, explaining that an analyst would simply use the most recent transaction that he or she had rated and then determine what the analyst needed to change. Tr. 1749-50. The analyst would also synthesize input from several people and sources. Tr. 1751-52. Similarly, in Snow's experience as a primary analyst, the rating rationale in the RAMP would be copied and pasted from the presale. Tr. 1754. Digney denied that Duka told him or anyone else to use debt service coverage ratios in the RAMP that were derived from Table 1 constants. Tr. 773-74.

On July 11, 2011, before issuing the presale for the seventh transaction, the Goldman deal, Fisher e-mailed Digney to ask whether Duka "want[ed] us to report the [debt service coverage] based on the blend as well as the stressed constant?"

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[44] Digney testified that, unlike new issuance, surveillance was using Table 1 constants. Tr. 438-39. He further testified that one could potentially justify "us[ing] a little less debt stress on the new issue side" because on that side, there were "additional cash flow stresses." Tr. 734. Duka made a similar argument to Hu in an e-mail sent in March 2011. Resp. Ex. 480 at 3-4.

Div. Ex. 103; *see* Tr. 456-59. Digney responded that he had spoken to Duka. Div. Ex. 103. During the hearing, Digney could not recall speaking to Duka but assumed he did because he reported doing so in the e-mail. Tr. 459. Duka also could not recall the conversation. Tr. 1237. Assuming Digney spoke to Duka, no evidence was presented regarding what he said to her or how he expressed Fisher's question. What is known is that Digney reported by e-mail that Duka "wants to show both the [debt service coverage] using stressed constant and the [debt service coverage] using actual constant." Div. Ex. 103.

The next day, S&P issued the 81-page presale for the Goldman deal. *See* Joint Ex. 68. Under the heading "Approach" and subheading "Conduit/fusion methodology," the presale provided the same information as in the Morgan Stanley presale: "In determining a loan's [debt service coverage ratio], Standard & Poor's will consider both the loan's actual debt constant and a stressed constant based on the property type, as further detailed in our conduit/fusion criteria." *Id.* at 19; *see* Joint Ex. 22 at 18 (Morgan Stanley presale). Digney recalled that the Goldman deal, like the seven other transactions, was rated using a blended constant. Tr. 460. On the presale for the deal, Digney and Fisher were listed as secondary contacts and Louis Cicerchia was listed as the primary analyst. Joint Ex. 68 at 1. The RAMP for this transaction listed Cicerchia as the primary analyst, Fisher as the backup analyst, and Digney as the chair. Joint Ex. 69 at 1, 5. Digney agreed that the fact the RAMP reported the use of Table 1 constants rather than blended constants was, as with JPMCC 2011-C4, due to sloppiness. Tr. 774, 777; *see* Joint Ex. 69 at 6.

1.6. Ratings withdrawal

Shortly after S&P published the Goldman deal presale, Jacob began receiving e-mails from market participants questioning it. Tr. 531. One e-mail's author described "[t]he subordination levels S&P allowed" in the deal as "stunning" and questioned Jacob's past comments about a troubling "slippage in underwriting quality." Div. Ex. 105. Jacob became troubled when he received an e-mail on July 15, 2011, from an investor named Ethan Penner in which Penner questioned how S&P could rate 96.25% of the transaction as BBB or better. Tr. 537-39; Div. Ex. 112.

Although Jacob felt he should rely on his analysts' judgment, he also felt compelled to investigate. Tr. 539. He first called Parisi and asked Parisi's opinion about the rating. Tr. 539. Parisi "didn't want to deal with it," so Jacob called Susan Barnes, a quality officer under Bukspan in the quality review group. Tr. 539-40; *see* Div. Ex. B-1.

Adelson first learned of a potential issue with S&P's rating after receiving a press inquiry about the "numbers" in the presale for the Goldman deal. Tr. 296-97; *see* Tr. 780. An internal investigation ensued. *See* Tr. 297-300. Adelson testified that, at some point, Duka said "she hadn't published the blended constant or explained the blended constant, [because] she didn't want to have to explain why new issu[ance] was different from surveillance." Tr. 300-01. Duka recalled that at the time "Adelson was very focused on the differences between new issuance and surveillance" and thought that in some way S&P should disclose that difference. Tr. 1240. Although she did not clearly remember the conversation, she opined that she likely expressed that such disclosure did not belong in a presale and likely belonged instead in a criteria document. Tr. 1240-41.

Jacob recalled having a number of meetings with senior personnel at S&P, including Sharma, Milano, Adelson, Osborne, and the chief legal officer. Tr. 540-41. Participants favored withdrawing the Goldman rating; Jacob opined that he was alone among the senior staff in urging that S&P not withdraw it. Tr. 541-42. He admitted that he later changed his opinion. Tr. 544-45. Adelson recommended withdrawal because he believed use of the blended constant was inconsistent with S&P's criteria. Tr. 308-10.

During this time, Goldman Sachs and Citigroup responded to market concerns and increased the credit enhancement levels in the Goldman deal to 20%. Div. Ex. 146 at 1, 13; Tr. 780-81.

These events prompted Adelson, who was under considerable pressure, Tr. 629, to draft and S&P to issue a succession of three advanced notices of proposed criteria changes, which Adelson referred to as ANPCCs, Tr. 310. S&P published these to explain that the blended constant was used by S&P to rate several transactions and to announce that it would investigate to determine whether to make a criteria change. Tr. 310-11.

S&P issued the first of these notices on July 27, 2011. Tr. 312; *see* Joint Ex. 6. At the same time, Adelson instructed Parisi to have criteria officers determine whether, based on the existing criteria guidance, the ratings issued in 2011 "could stand," meaning whether they were issued consistent with S&P's ratings definitions. Tr. 315-16. At first, the criteria officers said the ratings could not stand. Tr. 315. Adelson, however, pushed them to "look at it again." Tr. 318. The officers did so and concluded that the ratings "were consistent with the rating definitions." Tr. 318; *see* Div. Ex. 128.

In light of the first notice, the rating committee for the Goldman deal held a meeting, which was documented in a new RAMP. *See* Joint Ex. 71 at 1, 18. The meeting was attended by Duka, Digney, Pollem, Snow, and new issuance analyst David Mollin. *Id.* at 18. Notes from the meeting reflect that:

> The members of this committee strongly believe that the preliminary ratings, as originally assigned, were done so correctly, and in full compliance with S&P's then current

> criteria. However, in light of the Advanced Notice of Proposed Criteria Change and the uncertainty created thereby, we were left with no option but to withdraw the ratings. This in no way changes our opinion regarding this pool. This is the unanimous view of this committee.

Id.

The presale for FREMF 2011-K14 had been issued on July 18, 2011, six days after the Goldman presale. *See* Joint Ex. 77. The rating committee for FREMF 2011-K14 met July 28, 2011, the day after the Goldman rating committee met about the decision to withdraw the rating. *See* Joint Ex. 80. The members of the FREMF 2011-K14 committee—Duka, Digney, Pollem, and two other analysts—likewise disagreed with the decision to withdraw the ratings. *Id.* Notes from this meeting reflected that:

> The members of this committee strongly believe that the preliminary ratings, as originally assigned, were done so correctly, and in full compliance with S&P[']s then current criteria. However, in light of the Advanced Notice of Proposed Criteria Change and the uncertainty created thereby, we were left with no option but to withdraw the ratings. This in no way changes our opinion regarding this pool. This is the unanimous view of this committee.

Id.

Digney testified that he agreed to document his disagreement with the ANPCC and the decision to withdraw the ratings because documenting his disagreement "was the right thing to do." Tr. 785. Similarly, Henschke opined that use of a blended constant was consistent with the criteria article, which he viewed as "vague or unclear on a lot of points." Tr. 1705.

Digney and Henschke both denied that they participated in a scheme to decrease credit enhancement levels for the purposes of generating ratings business. Tr. 763-64, 1707. They were also unaware of such a scheme. Tr. 764, 1707-08. Digney was similarly unaware "in 2011 of any attempt [by anyone at S&P] to mislead readers of presale reports." Tr. 767. And Henschke testified that Duka never voiced any concern that (1) S&P was not rating enough conduit/fusion transactions; (2) she would lose her job; or (3) the CMBS group might be downsized. Tr. 1706-07.

Ultimately, Sharma decided, after consultation with senior staff, to withdraw the initial rating on the Goldman transaction. Tr. 308-09. S&P published a notice on July 28, 2011, that it was withdrawing its preliminary rating for the Goldman deal. Resp. Ex. 105. Also on July 28, 2011, S&P withdrew its rating of FREMF 2011-K14. Resp. Ex. 679.

At the same time, S&P began considering whether to amend its criteria. Tr. 387, 394-95. On Sunday, July 31, 2011, Jacob e-mailed Sharma with an update. Resp. Ex. 589 at 1. He explained that the contemplated changes to the criteria following the withdrawal were "not a correction of what was done," and that "what was done before," *i.e.*, the use of blended constants, "was a quite reasonable interpretation of the application of criteria."[45] *Id.* He noted that new issuance had "consistently rated based on the 50-50 blend of the stressed constant and actual debt service" and that surveillance had "used [a] 100 percent . . . stressed constant." *Id.* And the reason for this difference was that new issuance calculated debt service coverage ratio using stressed net cash flow as a numerator and surveillance used actual net cash flow. *Id.* Jacob explained that "using the stressed constant for debt service, and under-written cash flows for [net cash flow], for new deals would have been double counting." *Id.*

Adelson did not agree with Jacob's statement that the use of blended constants was a "quite reasonable interpretation of the application of criteria." Tr. 382.

Jacob directed CMBS to analyze all the transactions S&P rated in 2010 and 2011 using surveillance criteria. *See* Resp. Ex. 590; Tr. 1461-62. Accordingly, in early August 2011, surveillance personnel analyzed transactions as of the day they were issued and compared surveillance's ratings with new issuance's ratings. *See* Resp. Ex. 611. The analysis determined that the differences in credit enhancement levels were not significant. *Id.*; Tr. 1407-08; *see* Tr. 1426-27 (describing difference between surveillance and new issuance inputs); *see also* Resp. Exs. 605, 648-52, 654.

As part of the investigation, Parisi sent Adelson a spreadsheet that compared AAA credit enhancement levels for the four non-Freddie Mac transactions S&P rated in 2011 using the blended constants and using the "worse of" the Table 1 constant or the actual constants. Tr. 322-23; *see* Tr. 285; Div. Ex. 128 at 2. In an e-mail forwarding the spreadsheet, Parisi reported that the structured finance "criteria team . . . concluded that the results from the analysis of the four CMBS are consistent with our ratings definitions and criteria calibration." Div. Ex. 128 at 1;

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[45] Jacob testified that at some later point, his opinion changed. Tr. 658. This change resulted from his hearing shifting explanations of how S&P came to use blended constants. Tr. 665-66. He came to the conclusion that the switch to blended constants "was so much of a change" that it could not have been an interpretation. Tr. 667. "But," he testified, "that wasn't my biggest problem. My biggest problem was disclosure, always." Tr. 667.

see Div. Ex. 148 at 2. Parisi nonetheless testified that using the blended constant resulted in credit enhancement levels that were several hundred basis points lower than the "worse of" approach. Tr. 323.

S&P published a second ANPCC on August 5, 2011. Joint Ex. 7. S&P reported that since early 2011, S&P had used an average of two ratios to calculate a loan's debt service coverage ratio. *Id.* at 1. It also reported that "[o]ne ratio used the loan's actual debt service amount as a denominator" and the other used a hypothetical debt service amount. *Id.* According to Adelson, this statement turned out to be inaccurate. Tr. 325. Although the Division theorized that this inaccuracy was evidence that Duka was hiding information, Adelson did not confirm that theory. Tr. 325-27. He could not remember who provided the information he included in the August 5 notice. Tr. 326. The notice also provided that "[e]ffective immediately, Standard & Poor's will resume assigning ratings to new conduit/fusion transactions by applying the averaging approach described above." Joint Ex. 7 at 1. For Digney, this latter statement reinforced his opinion that using blended constants was consistent with the criteria article. Tr. 786.

Eleven days later, S&P published a third ANPCC, announcing that S&P had used a blended constant for all new ratings since early 2011 and showing how the debt service ratios in those transactions were calculated. Joint Ex. 8 at 1-2; Tr. 328. S&P stated that "the results produced" using the blended constant were "consistent with [its] rating definitions." Joint Ex. 8 at 1-2. It also explained that it would immediately resume rating transactions using the blended constant. *Id.* at 2. Adelson opined that with this notice, he and S&P finally "got it right." Tr. 328.

On cross-examination, Adelson said there was more going on than evidenced in the last ANPCC. Tr. 383-84. He testified that S&P was "going to send all the new deals to the criteria officers . . . and if [a deal] didn't pass, then we wouldn't put a rating on it." Tr. 383. Adelson did not include this information in the ANPCC "because [he] didn't want to publish something that was going to say [S&P wasn't] following criteria, because it's improper not to follow criteria." Tr. 384. He also said he expected S&P to quickly complete a new criteria article which he thought would not endorse use of a blended constant. Tr. 384, 394-95. When it became clear that it would take some time to produce a new criteria article, however, Adelson did not draft a new ANPCC. Tr. 395.

With reference to the language in the ANPCC regarding resuming the practice of using blended constants, Jacob was asked whether "it [was] true that S&P [could] only resume an approach that fits the requirements of criteria?" Tr. 646. He answered that "new ratings would have to follow criteria." Tr. 646. It follows that in S&P's collective opinion, as Jacob stated to Sharma on July 31, the use of blended constants was consistent with the criteria article.

S&P subsequently republished the presales for the Goldman deal and FREMF 2011-K14. Joint Ex. 75, 84. When the presales were republished, they listed the same credit enhancements that were listed in the original presales. Tr. 385-86. *Compare* Joint Ex. 68 at 4, *and* Joint Ex. 77 at 4, *with* Joint Ex. 75 at 4, *and* Joint Ex. 84 at 4. When he was asked about this fact, Adelson said that he did not "understand . . . how" anyone could "expect the credit enhancement to have changed on a deal that is already done and is held." Tr. 386. Notably, Morningstar also rated the Goldman deal and calculated the same credit enhancement levels as S&P. *Compare* Resp. Ex. 554 at 2, *with* Joint Ex. 68 at 4.

S&P eventually published new criteria in 2012. Tr. 795. The 2012 criteria article called for the use of actual constants. Tr. 795. Digney did not recall that anyone involved in the process ever said that Table 1 constants should be used. Tr. 796.

1.7. Industry perspective

1.7.1. Ethan Penner

Ethan Penner, who was called by the Division to testify, runs an investment fund that originates loans and owns them on behalf of the fund's investors. Tr. 677-78. He has a good deal of experience in the CMBS industry. Tr. 678-80. Penner opined that CMBS creates efficiencies that allow bond buyers to rely on the due diligence process performed by rating agencies so that the buyers no longer need to visit the collateral associated with the loans in question. Tr. 681-84; *see* Tr. 705-06 ("bond buyers don't have the capacity to do very much due diligence" and "larger bond buyers . . . generally don't go into the field to see properties or meet borrowers").

Penner testified that CMBS investors have between a week and a month after a CMBS deal is announced in which to make an investment decision. Tr. 682. In making an investment decision, Penner considers a number of factors, "starting with a rating of the security itself." Tr. 680. He testified that CMBS investors also rely on the issuers' disclosures, particularly with respect to the larger loans in the transaction, in addition to the characteristics of the loans. Tr. 683. Penner opined that CMBS investors use loan constants to judge the borrower's ability make debt payments. Tr. 701.

As a CMBS investor, Penner expected rating agencies to follow published criteria and that the agencies would consistently apply their standards. Tr. 687-88. To Penner, consistency is the "most important foundation of the industry." Tr. 688. He would assume that loan constants listed in a presale would be the loan constants actually used to rate a transaction. Tr. 720-21. If that were not the case, Penner would want to know. Tr. 721.

Because of the financial crisis and the loosening of rating standards that preceded it, Penner viewed the application of more conservative criteria as a positive development. Tr. 691-92; *see* Tr. 702-03. Penner testified that once S&P or Moody's rates a deal, no one cares how the second rating agency rates the deal. Tr. 715. Once the issuer obtains a rating from one of those two, it goes to a second rating agency and asks whether it can match the first one. Tr. 715. If it can, it will be hired; if it cannot, it will not be hired. Tr. 715. Penner does not know whether that is what actually happened with Morningstar's rating of the Goldman deal. Tr. 716.

1.7.2. Douglas Weih

Douglas Weih was called by the Division to testify. He works at Aegon USA Investment Management in Cedar Rapids, Iowa. Tr. 849. Aegon is a global financial services company. Tr. 852. Weih began at Aegon as a CMBS analyst and became head of Aegon's CMBS group in 2005. Tr. 852-53. In 2009, he was additionally made responsible for Aegon's residential mortgage-backed securities portfolio. Tr. 853-54. In 2012, he was placed in charge of all of Aegon's trading portfolio asset management. Tr. 854. In 2015, following a reorganization, he was made the head of Aegon's public fixed income group. Tr. 854.

In the 2010 to 2011 timeframe, Weih's team would have had less than a week to consider whether to invest in a new CMBS issuance. Tr. 862. As part of the decision whether to invest, his team's analyst would review and analyze the terms sheet and the top ten loans in the transaction. Tr. 864, 868. Weih's team did not actually visit the collateral. Tr. 866. The team would model cash flow and review the rating agency's presale, which he viewed as "another set of eyes" that might identify something his team missed. Tr. 867-68.

Weih and his team were concerned about downgrade risk, which he described as the risk that losses in the underlying loans would lead surveillance to downgrade the rating. Tr. 870; *see* Tr. 884-85. Because of downgrade risk, it was important to Aegon that surveillance and new issuance use the same rating methodology. Tr. 890. He testified that Aegon would not buy any CMBS conduit transaction rated less than AAA. Tr. 874-75.

Weih's team ran stress scenarios and also tried to replicate the rating agency's approach. Tr. 868-69. Weih denied, however, that his team would "outsource [its] due diligence." Tr. 871. He believed that rating agencies have access to more information about the transactions they rate than investors have. Tr. 872.

Weih reviewed presales to see what the rating agency liked and did not like, and his team used presales in conducting a deeper analysis at the property level. Tr. 876-77, 884. His team also used presales to compare the rating agency's value assessment with Aegon's. Tr. 884. Because it often contained boilerplate, Weih's team would not necessarily review the methodology section of the presale. Tr. 886-87. The team would instead focus on information specific to each deal. Tr. 887.

In looking at commercial real estate, Weih's team tried to determine the likelihood of underlying defaults. Tr. 880-81. In performing that analysis, they looked at the underlying collateral and credit enhancement levels. Tr. 881.

Aegon would normally have wanted to see one of Moody's, Fitch, or S&P on a transaction. Tr. 879. This was the case because other investors relied on those rating agencies. Tr. 879. Having Moody's, Fitch, or S&P rate the bond would thus allow Aegon to sell it if necessary. Tr. 879-80. Weih explained that a rating matters insofar as it determines price. Tr. 883.

If a rating agency changed its rating methodology, Weih would expect to see that change published. Tr. 887, 911. He would also want to know if issuers received information that differed from what investors were told. Tr. 889-90. Using two different sets of numbers might increase the risk of downgrade. Tr. 890.

1.7.3. Marc Peterson

The Division also called Marc Peterson to testify. He works as a managing director for Principal Real Estate Investors, which is part of Principal Global Investors. Tr. 1015. He has been with Principal's CMBS investment group since 1997. Tr. 1017. He oversees a team that manages a CMBS portfolio in excess of $9 billion. Tr. 1018.

Peterson testified that in making CMBS investment decisions, Principal will typically have five to seven days to decide whether to invest. Tr. 1028. In that time, Principal will "re-underwrite the risk" in the top 15 to 20 loans in the transaction, based on information from the issuer, and "then run[] those loans through [Principal's] model." Tr. 1024, 1026. Principal's investment decisions are limited by how far down the capital structure its clients will permit investment, *i.e.*, how far below AAA the client will permit Principal to invest. Tr. 1033-34.

Peterson testified that it is important to understand an agency's rating methodology so that an investor can understand the risk of downgrade. Tr. 1037-38. He is thus concerned with consistency and would expect to be told about changes in rating methodology. Tr. 1038, 1080-82. Peterson would also have been concerned if S&P were using numbers that differed from what was listed in the criteria article. Tr. 1047. This concern would have been fueled by Principal's concern about the possibility of future downgrades. Tr. 1048. Peterson thought the changes reflected in the criteria article were arbitrary and overly conservative. Tr. 1041-44.

Peterson is concerned about ratings to the extent they determine price. Tr. 1052. He said that loan constants are not a variable in Principal's models. Tr. 1058.

Peterson thought the Table 1 constants were intended to serve as a benchmark against which to judge other pools. Tr. 1073. He would thus expect an actual transaction's credit enhancement level to vary according to the makeup of the loans it comprised. Tr. 1073.

1.7.4. Matthew Reidy

Matthew Reidy, who was called by Duka to testify, is the senior CMBS portfolio manager at Fort Washington Investment Advisors, where he has worked since 2005. Tr. 1963. He has a master's degree in business. Tr. 1964. Fort Washington invested in CMBS during the time relevant to this proceeding, including transactions rated by S&P. Tr. 1965-67; *see* Resp. Ex. 881. Reidy researched Fort Washington's investments and decided whether and what to purchase. Tr. 1965-66.

In deciding whether to invest in a CMBS transaction, Reidy would consider the originator's term sheet and then "dig into" the top 15 properties in the transaction. Tr. 1967. Reidy would also consider cash flow for the properties. Tr. 1968.

Reidy testified that he considers a "stress scenario" at the end of the loan, at which point he would apply the rate Fort Washington sets for the property type in question. Tr. 1969-70. Having done that, he calculates the expected debt service coverage ratio on the expected new loan. Tr. 1970. Reidy said that Fort Washington would typically invest if he calculated no losses at the AAA level. Tr. 1971-72.

Reidy testified that the "specific metrics" found in rating agency presales were typically not relevant to his analysis.[46] Tr. 1975; *see* Tr. 1992 (testifying that metrics published in a presale made no difference to his investment decision); *see also* Tr. 1976. It was therefore the case in 2011 that Reidy did not read rating agency presales "as a matter of course." Tr. 1973. He estimated that he read about a quarter of presales for transactions in which he chose to invest. Tr. 1973. When he did review a presale, he did so either to double-check something or to find information not found in the term sheet. Tr. 1974; *see* Tr. 1989 (agreeing that the presales served as a "sanity check").

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[46] If he were to consider prior transactions to identify trends, he would look at Moody's debt service coverage ratio and loan-to-value metrics. Tr. 1976. He relied on Moody's because its methodology was more consistent and comparable than other rating agencies. Tr. 1976, 1979.

1.7.5. Kent Born

Duka called Kent Born to testify. Since 1995, he has worked for PPM America, a money management firm with over $100 billion in assets under management. Tr. 1996. He started with PPM America as a CMBS portfolio manager. Tr. 1997. Today he is co-head of PPM's real estate group and is responsible for CMBS, commercial mortgage lending, and all of PPM's involvement in commercial real estate. Tr. 1997-98. During 2009 to 2011, PPM's CMBS portfolio amounted to about $4 billion. Tr. 1998.

In 2011, Born's responsibilities included deciding which conduit/fusion transaction to recommend, from a credit perspective, that PPM purchase. Tr. 2005. On his recommendation, PPM purchased a tranche of MSC 2011-C1. Tr. 2005. In making a purchase decision, Born's team would review the term sheet and the presale and then "run" the pool through PPM's model before comparing "a whole host of different metrics" across different transactions. Tr. 2006. Born's team would then meet and discuss the transaction's top ten loans. Tr. 2006. Because PPM's approach was "significantly different from" that of the rating agencies, PPM did not compare its projected losses to the credit enhancement levels in the offering documents. Tr. 2007. How rating agencies calculated credit enhancement levels reported in presales "was not a big consideration" for PPM. Tr. 2015. PPM reviewed presales to see what rating agencies had to say about the 10 to 15 largest loans in the pool. Tr. 2008.

Born thought it important that rating agencies be consistent and agreed that it would be problematic if the agencies made methodological changes without telling the market. Tr. 2010-11.

1.7.6. Antony Wood

Antony Wood, who was called by Duka to testify, runs the structured products group at The Hartford. Tr. 2093. That group has over $25 billion in assets under management. Tr. 2093. In 2011, he managed the CMBS group and had about $16 billion in assets under management. Tr. 2095. The Hartford invested in conduit/fusion transactions in 2011, including four rated by S&P. Tr. 2095-96.

In making its investment decision, The Hartford would underwrite every loan in a transaction to determine the cumulative projected loss and an internal rating. Tr. 2098-2102. Wood's team "[t]ypically, . . . d[id] not look at the S&P pre-sale." Tr. 2103-04. In fact, Wood's team did not even obtain S&P's presales for two of the transactions in which The Hartford invested. Tr. 2104. Wood explained that because The Hartford had "lost so much money in CMBS through the [financial] crisis," it determined that it could not rely on rating agencies' ratings and instead developed its own ratings. Tr. 2104-05. He agreed that his team might refer to a presale just to ensure that they had not missed anything. Tr. 2121.

On cross-examination, the Division demonstrated that Wood's and the Hartford's perspective on CMBS investing was not typical. Tr. 2109-15. Wood agreed that he would expect S&P's presales to be truthful and accurate and would want S&P to publish changes to its methodology. Tr. 2116-17.

Beyond hurting S&P's credibility, Wood was uncertain whether S&P's withdrawal of the Goldman rating affected the market. Tr. 2107.

1.8. Hearing issues

During the interim between the seventh and eighth day of the hearing, after the Division rested, Duka's counsel raised an objection to the Division's plan to call Pollem as a rebuttal witness. Letter from Guy Petrillo (Dec. 28, 2016). During the eighth day of the hearing, Division counsel explained that the Division wished to call Pollem to rebut testimony Duka gave when she was examined by her counsel during the Division's case-in-chief. Tr. 1945. Specifically, Division counsel referenced Duka's testimony at transcript page 1393 about approving the language Pollem proposed that was included in the presales regarding disclosure of blended constants. Tr. 1943-45; *see* Tr. 1393; Resp. Ex. 387. According to the Division, because this testimony exceeded the scope of direct, and because the parties had agreed that Duka's counsel's cross of Duka could exceed the scope of direct, her testimony was not actually developed during its case-in-chief. Tr. 1945.

After reviewing the record and excerpts of investigative testimony, I concluded that the Division had explored during its direct examination of Duka her approval of the language in the presales regarding disclosure of blended constants. Tr. 2142; *see* Tr. 1227-30. As represented by Duka's counsel, Tr. 1941, 1947, I also concluded that the issue was addressed during the Division's investigation. Tr. 2142. During the last day of testimony, I asked Division counsel whether he was aware of any precedent that would support the position that a Plaintiff or prosecution could present evidence to rebut something that was developed during the plaintiff's or prosecution's case-in-chief. Tr. 2141. When counsel said that he had not located such a case, I suggested that the likely reason for that was that "when that happens, the solution is to call a witness to address whatever the evidence is." Tr. 2141. I then asked counsel whether he thought the Division would have been entitled to call a rebuttal witness even if Duka rested without calling any witnesses. Tr. 2142-43. Counsel asserted that the Division could do so. Tr. 2143. Because I disagreed, I sustained Duka's objection and barred the Division from calling Pollem to rebut Duka's testimony.[47]

Issues

1. Did Duka act with scienter and thus violate the antifraud provisions of the Securities Act and Exchange Act?

2. Did Duka negligently violate Section 17(a)(2) and (3) of the Securities Act?

3. Did Duka aid and abet and cause S&P's violations of Exchange Act Section 15E(c)(3) and Rules 17g-2(a)(6) and 17g-6(a)(2)?

2. Discussion and Conclusions of Law

2.1. Antifraud claims

Duka is charged with willfully violating Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5. 15 U.S.C. §§ 77q(a), 78j(b); 17 C.F.R. § 240.10b-5; OIP ¶ 49. She is alternatively charged with willfully aiding and abetting and causing S&P's violations of these same provisions. OIP ¶ 50.

Section 10(b), which applies "in connection with the purchase or sale of any security," makes it unlawful "[t]o use or employ . . . any manipulative or deceptive device or contrivance in contravention of . . . rules" set by the Commission. 15 U.S.C. § 78j(b). The term "manipulative" refers to actions "intended to mislead investors." *Dennis J. Malouf*, Securities Act of 1933 Release No. 10115, 2016 WL

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47 Tr. 2143, 2145, 2152; *see Marmo v. Tyson Fresh Meats, Inc.*, 457 F.3d 748, 759 (8th Cir. 2006) ("rebuttal evidence may be used to challenge the evidence or theory of an opponent—and not to establish a case-in-chief"); *Faigin v. Kelly*, 184 F.3d 67, 85 (1st Cir. 1999) ("The principal objective of rebuttal is to permit a litigant to counter new, unforeseen facts brought out in the other side's case."); *Morgan v. Commercial Union Assur. Cos.*, 606 F.2d 554, 555 (5th Cir. 1979) ("Rebuttal is a term of art, denoting evidence introduced by a Plaintiff to meet new facts brought out in his opponent's case in chief."); *see also Myers v. Cent. Fla. Invs., Inc.*, 592 F.3d 1201, 1225 (11th Cir. 2010) (holding that "there was no evidence to rebut" where defendants did not address an issue during their case); *Smith v. Conley*, 584 F.2d 844, 846 (8th Cir. 1978) ("Plaintiffs here can make no reasonable claim of ignorance as to defendant's theory of the shooting. Defendant's deposition and opening statement revealed the defense that the shooting was accidental, and plaintiffs' evidence of a deliberate aiming and firing of the revolver controverted the defense.").

4035575, at *6 (July 27, 2016). A deceptive device or act refers to "conduct that produces a false impression." *Id.*

The Commission implemented the authority provided in Section 10(b) by promulgating Exchange Act Rule 10b-5. *Dennis J. Malouf*, 2016 WL 4035575, at *7. Rule 10b-5 makes it unlawful:

> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. Rule 10b-5 is broadly worded and "is 'designed to encompass the infinite variety of devices'" that are inimical to "fair dealing." *Dennis J. Malouf*, 2016 WL 4035575, at *7. The three subsections in Rule 10b-5 overlap and are "mutually supporting rather than mutually exclusive." *Id.* at *9.

To demonstrate liability under Rule 10b-5, the Division must show that Duka acted with scienter. *Dennis J. Malouf*, 2016 WL 4035575, at *7. "[T]he term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). The term "includes recklessness," which is "'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the [respondent] or so obvious that the [respondent] must have been aware of it.'" *Gregory O. Trautman*, Exchange Act Release No. 61167A, 2009 WL 6761741, at *16 (Dec. 15, 2009) (quoting *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 704 (7th Cir. 2008)). "Scienter may be inferred from circumstantial evidence." *Brian A. Schmidt*, Exchange Act Release No. 45330, 2002 WL 89028, at *8 (Jan. 24, 2002). The necessary corollary to this last point is that circumstances may also show a lack of scienter.[48]

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[48] Courts have held that "[a] defendant may only be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rule[] 10b-5(a) or (c) when the scheme also encompasses conduct beyond those misrepresentations or omissions." *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir. 2011); *see also Pub. Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972, 987 (8th Cir. 2012); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177-78 (2d Cir. 2005); *SEC v. St. Anselm Expl. Co.*, 936 F. Supp. 2d

Section 17(a), which applies "in the offer or sale of any securities," makes it unlawful:

> (1) to employ any device, scheme, or artifice to defraud, or
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a).

To find a violation of Exchange Act Section 10(b), Rule 10b-5 thereunder, or Securities Act Section 17(a), the misconduct must have occurred by means of interstate commerce. 15 U.S.C. §§ 77q(a), 78j(b); 17 C.F.R. § 240.10b-5(b).

Similar to Rule 10b-5, the paragraphs under Section 17(a) "are 'mutually supporting rather than mutually exclusive,'" and do not "'narrow the reach of'" their neighboring paragraphs. *Dennis J. Malouf*, 2016 WL 4035575, at *11 (citations omitted). Unlike under Rule 10b-5, conduct encompassed by Section 17(a) need not "itself be 'manipulative or deceptive.'" *Id.* at *10-11. To prove a violation of Section 17(a)(1), the Division must show scienter or deceptive intent. *Id.* at *11. But the Division can prove violations of paragraphs (2) and (3) by demonstrating negligence, which is the "failure to exercise reasonable care." *Ira Weiss*, Securities Act Release No. 8641, 2005 WL 3273381, at *12 (Dec. 2, 2005), *pet. denied*, 468 F.3d 849 (D.C. Cir. 2006).

A misstatement or omission of a material fact could constitute a device or artifice for purposes of Section 17(a)(1). *Dennis J. Malouf*, 2016 WL 4035575, at *11. In comparison to paragraph (1), which prohibits "scienter-based fraud," paragraph (2) bars "negligent misrepresentations that deprive investors of money or property." *Id.* Because paragraph (3) is directed at "any transaction, practice, or course of business" it does not apply to single acts. *Id.* at *12. Repeated acts, however, could fall within the terms of paragraph (3). *Id.*

1281, 1298-99 (D. Colo. 2013); *SEC v. Benger*, 931 F. Supp. 2d 908, 913-16 (N.D. Ill. 2013); *SEC v. Familant*, 910 F. Supp. 2d 83, 93-94 (D.D.C. 2012); *In re Nat'l Century Fin. Enters., Inc., Inv. Litig.*, No. 2:03-MD-1565, 2006 WL 469468, at *21 (S.D. Ohio Feb. 27, 2006). In *Dennis J. Malouf*, the Commission disagreed with this approach. *See* 2016 WL 4035575, at *5-11 & n.14.

2.1.1. Scienter-based claims

Resolution of the scienter-based charges under Securities Act Section 17(a)(1), Exchange Act Section 10(b), and Exchange Act Rule 10b-5 comes down to whether the Division met its burden to show that Duka acted with the intent to deceive, manipulate, or defraud. Considering the record, there is no evidence that Duka acted with such intent. Instead, the evidence tells a different story that is inconsistent with the Division's arguments. It demonstrates that Duka, in effecting the switch to using blended constants, did so for analytical reasons—rather than for commercial or professional gain—and with the knowledge of appropriate S&P personnel.

In the second half of 2010, life in new issuance—the S&P subgroup that Duka managed—grew increasingly hectic. It is clear that Duka was under stress and increasingly felt that she had insufficient resources to deal with the expected influx of business. *See* Resp. Ex. 316 (stating that she was "going to need help NOW"); Tr. 1339 ("I'm concerned that I don't have adequate staffing to complete the work . . . in the manner that I would like"). Each month, the reports she and Thompson sent to Osborne described how CMBS was increasingly stretched thin. *E.g.*, Resp. Ex. 211 at 4 (of paginated pages). Notably, the Division characterizes these reports as if they were written by Duka alone, when in fact, Thompson was a co-sender. *See, e.g.*, Div. Proposed Finding No. 36. But the Division offers no reason to doubt Thompson's assessment of CMBS's workload.

During this time, Duka even took to chiding her superiors about the fact that competitors were hiring more analysts while she was stuck with the same number of people. Resp. Ex. 272. Duka's level of anxiety was not a secret. Even Jacob remarked on it once when he noted that the pace of new issuances was expected to increase. Resp. Ex. 259. These facts do not paint a picture of someone who was worried she or her people would lose their jobs. *See* OIP ¶ 5 (alleging that Duka perceived "her position within the firm" to be threatened).

During this same time, Henschke and then Pollem voiced their concerns about the use of Table 1 constants. Henschke thought that using Table 1 constants did not make sense because they predicted defaults that were unlikely in the existing low interest rate environment. Tr. 1692-93, 1697-99, 1711-12, 1723-24. Henschke confirmed that he discussed his opinion about Table 1 constants with "probably almost everyone." Tr. 1699-1700. Thompson recalled that Henschke and Pollem had concerns about using Table 1 constants. *See* Tr. 178. Digney likewise came to believe that using Table 1 constants did not make analytical sense. Tr. 478-79, 731. Indeed, he subsequently concluded in April 2011 that even the use of blended constants was too conservative for term default tests and proposed using only actual constants. Resp. Ex. 473 at 2; Resp. Ex. 514 at 3.

Accordingly, the evidence shows that rather than trying to ease ratings to generate business, Duka acted in response to her senior subordinates' concerns about the analytical deficiencies associated with using Table 1 constants. Also, there was no evidence that Duka was afraid she or anyone else would lose their jobs. Digney and Henschke both denied that they participated in a scheme to decrease credit enhancement levels using blended constants so as to generate business and further denied being aware of any such scheme. Tr. 763-64, 1707-08. Digney testified that he never heard Duka tell anyone to report debt service coverage in feedback using blended constants but to not use that information in the presale. Tr. 769. And Henschke affirmed that Duka never said to him she was concerned that: (1) S&P was not rating enough conduit/fusion transactions; (2) she would lose her job; or (3) the CMBS group might be downsized. Tr. 1706-07.

It was against this backdrop, with all senior members of her team expressing doubts about whether it made sense to use Table 1 constants, that Duka approached Parisi about using blended constants. It was not until December 2010, that Duka said that Henschke had "start[ed] to convince [her] that [CMBS] should rethink" the use of Table 1 constants because their use did "not have the intended result." Resp. Ex. 318 at 6.

The Division says Duka's meeting with Parisi on December 14, 2010, was merely part of a ploy to generate business for S&P. Div. Posthearing Br. at 10. The Division paints the meeting as a nefarious "informal discussion" designed to evade notice and keep the use of blended constants "under the radar at S&P." *Id.* But raising the issue in the first instance with Parisi, the criteria officer at the time, was exactly what the criteria change process guidelines instructed Duka to do. *See* Tr. 648, 1491; Joint Ex. 10 at 1 ("Analysts are encouraged to consult with . . . criteria officers with application and interpretation questions."); *id.* at 8, 17. Those guidelines say nothing about how formal an analyst's discussion or decision with a criteria officer should be. Further, as Parisi said, a criteria officer could decide whether an analytical approach represented an interpretation rather than a change requiring a criteria amendment. Tr. 1549. And the characterization of the meeting as "under the radar" is apparently based on the Division's belief that Duka had some responsibility to document her meeting with Parisi. *See* OIP ¶ 30. Both Thompson and Duka, however, testified that it would have been Parisi's job to document the meeting. *See* Tr. 187, 1139, 1159. No contrary evidence was presented.

Although it is not entirely clear what happened at the December 14 meeting with Parisi, later events paint a picture and show whose testimony about the meeting is reliable. Based on that testimony, I conclude that Parisi knew about and approved the use of blended constants on December 14, 2010.

As an initial matter, it is evident that at some point before April 20, 2011, Parisi and his direct report, Geramian, were aware of the use of blended constants. Other than saying "[t]hanks," Geramian did not respond to Digney's e-mail on April 20 in which Digney specifically said that "[w]e are currently using a 50/50 blend of actual loan constants and the stressed loan constants set forth in the criteria." Resp. Ex. 473 at 1-2. If, as the CMBS criteria officer since mid-December 2010, Geramian had a problem with the use of blended constants, this would have been an appropriate time to raise his concern to others, including his boss, Parisi. There is no evidence, however, that he raised any concerns. Parisi also did not react a month later, on May 21, when he was directly presented with the same information. *See* Tr. 793-94, 1569-75; Resp. Ex. 517 at 4; Resp. Ex. 518 at 1; Resp. Ex. 657 at 7. Given that Parisi was Geramian's boss, the only reasonable conclusion that follows from these two facts is that Parisi was aware of new issuance's use of blended constants before April 20.

The question, therefore, is when in the period of December 14, 2010 to April 20, 2011, Parisi learned of the use of blended constants. It is possible that because everyone in new issuance knew about such use by March 2011, Tr. 437-38, 773, Parisi and Geramian simply gleaned that information from interacting with new issuance staff members. But if Parisi and Geramian were previously unaware of the use of blended constants and simply learned about that use through staff interactions, it is difficult to imagine one or both of them not questioning why blended constants were being used. *See* Joint Ex. 10 at 6, 8 (describing the responsibilities of the criteria organization and criteria officers). No evidence was presented, however, that Parisi and Geramian raised such questions. I therefore conclude that Parisi learned about the use of blended constants before March 2011.

This leaves the December 14 meeting between Duka, Thompson, and Parisi. Although Parisi denied approving the use of blended constants at the December 14 meeting, he admitted that his memory was suspect. Tr. 1516, 1587-88. In fact, it is evident that Duka had two separate meetings with Parisi during this period in late 2010; Duka testified that, of the two meetings, one concerned Freddie Mac deals specifically and the other—the December 14 meeting attended by Thompson—concerned CMBS's overall use of blended constants versus Table 1 constants. Tr. 1136, 1138-40, 1385-87, 1392. Parisi first recalled only the meeting with Duka and Thompson, and stated that it concerned a Freddie Mac deal. Tr. 1511-15, 1575. But the spreadsheet that Duka likely used with Parisi during the December 14 meeting, which Henschke likely created on December 13, did not involve a Freddie Mac deal, which would have been odd if the meeting was specific to such a deal. Tr. 1379-81, 1441, 1702; Resp. Ex. 670C. By the end of his cross-examination, Parisi conceded that he could no longer deny that there was a second meeting. Tr. 1587-88.

Thompson was also present at the December 14 meeting but his testimony and later actions were equivocal. Contrary to his allegedly expressed concern, Tr.

95-96, 192, he did not "socialize" the use of blended constants when given the chance, *see* Resp. Ex. 334 at 2; Div. Ex. 71 at 3, 6, 8. And while he said that Parisi's flexibility on using blended constants was not "programmatic," Tr. 94, he testified that Parisi said "there was room for analysts' judgment in regard to the work or the assumptions as the analysis was being conducted." Tr. 93. He also agreed that Parisi conveyed that analysts had the "*discretion . . . to potentially average constants*" and thought the meeting concerned getting clarity about the "guidelines and boundaries" for analysts' exercise of judgment. Tr. 183-85 (emphasis added). This is consistent with Duka's recollection. As Duka pointed out, it would not have made sense, from a consistency standpoint, to use blended constants only for one rating. Tr. 1140-42. If it made sense to use blended constants in one rating—and Parisi said it did insofar as a Freddie Mac transaction, Tr. 1515-16, 1559—it would make sense for the others, as well, *see* Tr. 1575-76 (Parisi conceding it would be logical to apply this interpretation to other Freddie Mac transactions).

Thompson was not asked whether the meeting he attended concerned a Freddie Mac deal, but his testimony suggests that the discussion was general and not specific to Freddie Mac deals. Notably, Thompson thought that Parisi was generally "open to using different constants" so long as the usage was documented. Tr. 93. He also testified that the discussion involved "a general dialogue about the framework." Tr. 91.

Given the foregoing, I conclude that Parisi learned of and approved the use of blended constants during the December 14, 2010, meeting at which Thompson was also present. I also conclude that none of Duka's meetings with Parisi were part of a ploy.

In addition to the facts discussed above about Duka's motivation, her assertion that she acted for analytical reasons is circumstantially supported by what happened once S&P determined to withdraw its preliminary rating for the Goldman deal. First, Jacob e-mailed S&P's president, Sharma, on July 31, 2011, and explained that the contemplated changes to the criteria following the withdrawal were "not a correction of what was done," and that "what was done before," *i.e.*, the use of blended constants, "was a quite reasonable interpretation of the application of criteria." Resp. Ex. 589 at 1. Second, with withdrawal of the Goldman deal imminent, the members of the rating committee for the deal held a meeting and stated in writing that they "strongly believe[d] that the preliminary ratings, as originally assigned, were done so correctly, and in full compliance with S&P's then current criteria." Joint Ex. 71 at 18. The members of the rating committee for the FREMF 2011-K-14 deal reached the same conclusion in writing. *See* Joint Ex. 80. Third, in the final ANPCC, S&P announced its use of blended constants and stated that "the results produced" using the blended constant were "consistent with [its] rating definitions." Joint Ex. 8 at 1-2. S&P also explained that it would immediately resume rating transactions using this method. *Id.* at 2. As

Jacob admitted, S&P could only *resume* rating transactions using blended constants if that "approach . . . fit[] the requirements of criteria." Tr. 646. Fourth, when the presales for the two withdrawn ratings were republished, they listed the same credit enhancements that were listed in the original presales, with no indication on these listings that the credit enhancements would have differed had Table 1 constants been used. Tr. 385-86. *Compare* Joint Ex. 68 at 4, *and* Joint Ex. 77 at 4, *with* Joint Ex. 75 at 4, *and* Joint Ex. 84 at 4. Fifth, S&P essentially repudiated the use of Table 1 constants in its 2012 criteria article. *See* Tr. 795-96.

To be clear, this is not to say that using blended constants or Table 1 constants produced better results. Whether using blended constants or Table 1 constants was better is largely irrelevant and not a matter about which I could opine. *See* 15 U.S.C. § 78*o*-7(c)(2). It is for each rating agency to determine how best to rate transactions. *See id.* Had Duka's decision been analytically unsound, however, one might expect that some personnel at S&P would have said so at the relevant times. But that did not happen.

In the facts section of its brief, however, the Division asserts that "Duka was acutely aware" that S&P was losing out on rating engagements because its 2009 criteria was resulting in S&P assigning higher credit enhancement levels. Div. Posthearing Br. at 8-9. It notes Thompson's testimony that Duka remarked on the effect of S&P's credit enhancement levels and the fact that Thompson and Duka regularly reported to supervisors that CMBS had lost engagements because of conservative criteria. *Id.* at 8. Although it does not exclusively rely on these factors in asserting that Duka acted with scienter, it is apparent that the Division believes Duka's "acute aware[ness]" shows that she did, and that she was "motivated by a desire to attract paid ratings business at the expense of ratings integrity." *See id.* at 36-38.

It is true that Duka *and Thompson* regularly reported to Osborne, their supervisor, about lost engagements and explained the multiple reasons—including S&P's credit enhancement levels—why engagements were lost. But submitting monthly activity reports was a required part of their job. Tr. 72, 74. And the Division does not claim those reports were inaccurate. If Duka and Thompson were going to report lost opportunities, it is unclear why it would be unreasonable or suspicious that they would explain why those opportunities were lost. Accurately reporting news directly related to one's job hardly evidences nefarious intent—especially since management was interested in knowing whether S&P had been engaged to rate particular deals and why. *See* Resp. Ex. 245. And no one thinks that credit enhancement levels—*sometimes* the reported cause of lost engagements—

were irrelevant to issuers.[49] The fact Duka *and Thompson* remarked on the fact of the lost engagements does not show Duka acted based on a commercial interest.

Putting Duka's alleged acute awareness aside, the Division's argument that it demonstrated scienter proceeds as follows. According to the Division the strongest—or at least the first—indication that Duka acted with scienter is inferential: if using actual constants was analytically justified, there would have been no reason not to simply switch to actual constants, as opposed to blended constants, and announce that switch. Div. Posthearing Br. at 37. Presumably, the Division is suggesting that because Duka did not truly believe any change away from using Table 1 constants was analytically justified, she chose a less dramatic change to blended constants to avoid "subject[ing] her proposal to [the] internal scrutiny" that might accompany a more dramatic shift to actual constants. *Id.* at 37.

Putting aside the lack of evidence for the Division's position, it is not clear why this would necessarily be so. The point of using Table 1 or blended constants was to stress the loans in question. As Parisi conceded, the use of a blended constant also stressed the loans—albeit to a lesser degree than using pure Table 1 constants—because the blended constant was higher than the actual constant. Tr. 1567; *see* Resp. Ex. 670C, sheet 2. And while it may have been that no one could explain why CMBS chose a 50/50 blend, as opposed to a 60/40 or some other blend, *see* Tr. 1144-46, that fact did not make the Table 1 constants any less arbitrary than the use of the blended constants. As noted, the criteria committee settled on Table 1 constants after throwing some numbers up on a whiteboard and collectively agreeing—without documenting any methodology, discussion, or vote—that the numbers looked right. Tr. 65-66, 119-120; *see* Resp. Exs. 108-19. Conversely, blended constants were tied, at least partially, to actual constants and thus had some basis in reality.

There was much evidence that blended constants also mitigated the extreme or unrealistic results predicted by use of the Table 1 constants. *See* Tr. 813-14, 1165-66, 1375-78, 1692-99, 1723-24. And, even Parisi thought that Duka's proposal and analysis made sense, at least with respect to particular transactions, and "[t]hat the basis was analytical." Tr. 1515-16, 1559, 1575-76. Especially in light of the evidence that many thought usage of blended constants was analytically sound, Duka's desire to use blended constants as opposed to other types of constants is not, in and of itself, evidence of deceptive intent.

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49 Indeed, the most significant reason that S&P lost out on ratings engagements during the second half of 2010 was issuers' dissatisfaction with S&P's terms and conditions, not its methodology. *E.g.*, Resp. Ex. 234 at 3 (of paginated pages); Resp. Ex. 245 at 1; *see* Div. Ex. 61 at 2 (of paginated pages) (reporting on December 13, 2011, a "significant increase in rating activity, since the revised terms & conditions have been distributed").

The Division also points to Duka's approval of the vague "consider both" language for the presales and her alleged instruction to Digney not to report the use of blended constants in the presale for the Goldman deal. Div. Posthearing Br. at 14-15, 37. Although it is true that Duka approved the "consider both" language, Tr. 1230, 1393, saying that her approval of it reflects her intent to deceive is a stretch. The language was actually drafted by Pollem who, months before, had raised concerns about the analytical soundness of using Table 1 constants. *See* Resp. Ex. 387 at 2; Tr. 178, 1392-93. No one suggested that Pollem was motivated by anything other than a desire to use an analytically sound methodology. And there was no evidence that Duka gave Pollem any directions regarding this language or the disclosure of CMBS's constants.

Moreover, saying that Duka told Digney not to report the use of blended constants in the presale for the Goldman deal overstates what happened. In his responsive e-mail to Fisher on July 11, 2011, Digney reported that Duka said "she want[ed] to show both the [debt service coverage ratio] using stressed constant and the [debt service coverage ratio] using actual constant." Div. Ex. 103. But neither Digney nor Duka could remember whether they actually had a conversation about Fisher's question or, if they did, what was said. Tr. 459, 1237. It is a fact, however, that the disclosure in the Goldman presale matched the disclosure in the Morgan Stanley presale. Joint Ex. 22 at 18; Joint Ex. 68 at 19. This fact raises the possibility that Duka simply said to continue the current practice. But regardless, there is no evidence she affirmatively told Digney not to report the use of blended constants or that she gave the matter any specific thought.

The Division relies on two final points. It points to Adelson's testimony that in July 2011 Duka said she did not publish use of blended constants because she did not want to explain the differences between new issuance and surveillance.[50] Div. Posthearing Br. at 37; *see* Tr. 300-01. It also says Duka failed to ensure that Hu received a copy of new issuance's model as part of Hu's model quality review. *Id.* at 38.

As to the latter point, there is no evidence that Hu asked for and was refused access to the model. *See* Tr. 832-33. There is also no reliable evidence that Duka was responsible for giving model quality review CMBS's model, let alone that she had an affirmative responsibility to ensure that Hu was reviewing the correct

[50] The Division also purports to rely on its exhibit 209 and Jacob's testimony. Division exhibit 209, which was not admitted, merely reflects Adelson reporting his conversation with Duka and is thus not an additional source of evidence about what Duka said. And Jacob did not testify that Duka said she did not want to explain differences between new issuance and surveillance. *See* Div. Posthearing Br. at 15. Instead, he could not remember how he heard that someone said "we didn't want to have to explain this to the public." Tr. 666.

model. Indeed, the Division's argument that Duka "was responsible for making sure [model quality review] received accurate information" rests on a weak foundation. Instead of providing some direct evidence of Duka's responsibilities, it relies on Digney's agreement that he "guess[ed]" it is fair to say Duka "was ultimately responsible for providing whatever [model quality review] needed to perform this assessment" and his following testimony that he did not "know if there's anything specific . . . in the policy and procedure document that says who does. But I guess that makes sense." *See* Div. Posthearing Br. at 18 (citing Div. Finding of Fact No. 97, which in turn cites Tr. 810-11). Digney's speculation does not show that Duka had an affirmative responsibility to make sure model quality review had the correct model. And Division counsel's examination of Digney demonstrated that it was not until he testified in December 2016 that Digney realized Hu might have been reviewing the wrong model. *See* Tr. 806-09. There is no evidence that anyone in 2011 thought Hu might have been looking at the wrong model.

The Division thus moves to a fallback that Duka's communications with Hu were unclear. Div. Posthearing Br. at 18. But the evidence shows that by the time Duka responded to Hu in late April 2011, a large number of people within S&P, including all of new issuance and CMBS's criteria officer were aware of the use of blended constants. That usage was not a secret and there is no evidence anyone was trying to hide it.

The Division also ignores what actually transpired. In late April 2011, Duka prepared to respond to Hu's request. *See* Resp. Ex. 480 at 1. Rather than e-mailing only Hu with an intentionally opaque answer, Duka first e-mailed Digney and Ramkhelawan with a suggested response, asking them both to review her proposed response "to make sure [she was] explaining this right." *Id.* Only after both responded that her description appeared correct, *id.*, did Duka respond to Hu, copying Digney, Ramkhelawan, and Pollem, Resp. Ex. 479 at 1. By asking Digney and Ramkhelawan to make sure she explained the matter correctly, Duka demonstrated that she was not trying to hide anything from Hu.

And Hu understood. She forwarded a draft framework model a week later, on May 2, 2011. *See* Resp. Ex. 499. The draft accurately provided that loan constants used in the model were a combination of actual loan constants and Table 1 constants. *Id.* at 30. True enough, Hu did not say the constants were a 50/50 combination, but she did say they were a combination, which is an accurate depiction.

This leaves Duka's remark to Adelson that she did not publish use of blended constants because she did not want to explain the methodological differences between new issuance and surveillance. Although this remark is more concerning, it is not sufficient to show that Duka acted with scienter. By failing to address the evidence that Duka's group had more work than it could handle and that Duka acted because her subordinates had convinced her that using Table 1 constants was analytically unsound, the Division ignores the context. Its position is thus undercut by its failure to engage all of the affirmative evidence that Duka acted out of a desire to produce analytically sound ratings. Given that unaddressed context, it is entirely plausible that what Duka actually said to Adelson was that she did not want to explain the differences *in a presale* because that sort of general explanation belonged in a criteria document, not a transaction-specific presale. Tr. 1240-41.

Given the foregoing, I reject the charges that Duka acted with scienter. The allegations under Securities Act Section 17(a)(1), Exchange Act Section 10(b), and Exchange Act Rule 10b-5 are dismissed. To the extent the allegations under Securities Act Section 17(a)(2) and (3) are premised on scienter, those allegations are dismissed as well.[51]

2.1.2. Negligence claims under Securities Act Section 17(a)(2) and (3)

As noted, negligence—the "failure to exercise reasonable care"—is sufficient to demonstrate violations of paragraphs (2) and (3) of Securities Act Section 17(a). *Ira Weiss*, 2005 WL 3273381, at *12. To demonstrate liability under paragraph (2), the Division must show that Duka negligently "obtain[ed] money or property by means of any untrue statement" or "omission" "of a material fact." 15 U.S.C. § 77q(a)(2). To demonstrate liability under paragraph (3), the Division must show that Duka negligently "engage[d] in any transaction, practice, or course of business which operate[d] or would [have] operate[d] as a fraud or deceit upon [a] purchaser." 15 U.S.C. § 77q(a)(3). For the reasons outlined below, the Division's negligence claims fail under subsection (a)(2) but prevail under (a)(3).

As to the threshold requirements for Section 17(a)(2) and (a)(3) liability, the alleged failure to adequately disclose the use of blended constants occurred in the offer or sale of securities and occurred by means of instrumentalities of interstate commerce. Issuers solicited ratings in the course of preparing to issue CMBS transactions and provided the rating presales to investors. Tr. 72, 879-80, 1027-28. And investors considered the presales and ratings described in them to a greater or lesser degree in deciding whether to invest. Tr. 871-72, 1778-79, 2060. These facts are sufficient to satisfy the broadly defined term "in the offer or sale of any securities." *See United States v. Naftalin*, 441 U.S. 768, 773 (1979). Additionally, issuers sent the presales, prepared in New York, to investors located in other states, such as Iowa. Tr. 848-49, 1015. This is sufficient to meet the interstate commerce or mails requirement. *See United States v. Roby*, 499 F.2d 151, 152-53 (10th Cir. 1974).

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[51] Duka's lack of scienter also means the Division's alternative argument—that she aided and abetted S&P's violations of the antifraud provisions, OIP ¶ 50, Div. Posthearing Br. at 31 n.29—fails. *See Mohammed Riad*, Exchange Act Release No. 78049A, 2016 WL 3627183, at *17 n.41 (July 7, 2016).

Section 17(a)(2). For two reasons, the Division's case under subsection (a)(2) breaks down on the question of whether Duka "obtain[ed] money or property by means of any untrue statement" or "omission." The first reason is that the Division presented no evidence that Duka received any money or property. The second reason is that no money or property was acquired "by means of" the statements or omissions in the presales.

On the first point, the Division argues that the fact "S&P obtained" money in the form of fees for rating CMBS transactions is enough to prove that Duka obtained money or property.[52] There is a split of authority on the issue of whether obtaining money for one's employer is sufficient to meet the obtaining money element. In *SEC v. Stoker*, the court held that:

> It would be contrary to [the statute's] language ["directly or indirectly"], and to the very purpose of Section 17(a), to allow a corporate employee who facilitated a fraud that netted his company millions of dollars to escape liability for the fraud by reading into the statute a narrowing requirement not found in the statutory language itself.

865 F. Supp. 2d 457, 463 (S.D.N.Y. 2012); *see SEC v. Mudd*, 885 F. Supp. 2d 654, 669-70 (S.D.N.Y. 2012) (applying *Stoker*).

In *SEC v. Syron*, on the other hand, the court framed the issue as "turn[ing] on whether [the defendants] can be said to have 'obtained' money or property when they did not, in fact, gain personal possession of either." 934 F. Supp. 2d 609, 638 (S.D.N.Y. 2013). The court turned to various dictionaries to see how the word "obtained" was defined around 1933, when the Securities Act was passed. *Id.* Because the dictionaries the court consulted defined the word as "to acquire," "to get and retain possession," or "to get hold of," the court concluded that the "definitions make clear that to obtain an object is to gain possession of it." *Id.* Because the defendants' employer gained possession of money but the defendants did not, the court in *Syron* rejected the interpretation in *Stoker*. *Id.* at 638-40; *see SEC v. Wey*, No. 15-CV-7116, 2017 WL 1157140, at *11-12 (S.D.N.Y. Mar. 27, 2017) (following *Syron*); *SEC v. DiMaria*, 207 F. Supp. 3d 343, 358 (S.D.N.Y. 2016) (same).

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[52] Div. Posthearing Br. at 30 n.28 (relying on *SEC v. Stoker*, 865 F. Supp. 2d 457, 463 (S.D.N.Y. 2012) for the proposition that "it is sufficient under Section 17(a)(2) for the SEC to allege that [the defendant] obtained money or property for his employer while acting as its agent, or, alternatively, for the SEC to allege that [the defendant] personally obtained money indirectly from the fraud"); *see* Div. Response Br. at 3-4 ("It is sufficient that the respondent obtained money or property for her employer while acting as its agent.").

Syron has the better of this argument. When determining the meaning of a statute, the "first step . . . is to determine whether the language at issue has a plain and unambiguous meaning." *Robinson v. Shell Oil Co.*, 519 U.S. 337, 340 (1997). Statutory language should be interpreted consistent "with its ordinary or natural meaning" at the time the language was enacted. *See Dir., Office of Workers' Comp. Programs, Dep't of Labor v. Greenwich Collieries*, 512 U.S. 267, 272 (1994); *Perrin v. United States*, 444 U.S. 37, 42 (1979). Resort to dictionary definitions contemporary to the time of enactment is an accepted way of determining the ordinary meaning of statutory language. *See Taniguchi v. Kan Pac. Saipan, Ltd.*, 566 U.S. 560, 566-67 (2012); *Amoco Prod. Co. v. S. Ute Indian Tribe*, 526 U.S. 865, 874 (1999).

Syron makes clear that at the time the Securities Act was passed, the word *obtain* connoted acquiring possession or getting hold of something. 934 F. Supp. 2d at 638. This understanding suggests that obtaining something—getting hold of it—is a personal act. It follows that Duka cannot be said to have obtained something she never acquired, held, or possessed. Saying Duka acquired, held, or possessed money she never actually acquired, held, or possessed ignores the plain meaning of the word obtain. And there is no indication that she indirectly obtained money due to some control over or personal benefit from whatever was received by her employer. Indeed, the Division does not seek disgorgement and does not argue that Duka was enriched by her actions. *See* Div. Posthearing Br. at 41-43.

Even putting this problem aside—even assuming one could say that Duka obtained money because S&P received money—the question would remain whether she obtained money "*by means of*" the statements or omissions in the presales.[53] The evidence shows that the issuers incurred the obligation to pay S&P well before their presales were issued. For instance, the engagement letter for the Morgan Stanley deal was signed December 13, 2010, Joint Ex. 21, before Duka spoke to Parisi on December 14 and before Pollem suggested language for the presale on February 2, 2011, *see* Resp. Ex. 387; Tr. 1392-93. And the presale was issued on February 4, nearly two months after the engagement letter was signed.[54] *See* Joint Ex. 22.

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[53] 15 U.S.C. § 77q(a)(2) (emphasis added); *see* Div. Prehearing Br. at 6 (tying the Section 17(a)(2) claim to "material misstatements and omissions in S&P publications, specifically its Presale reports"); Div. Posthearing Br. at 30 & n.28 ("As Section 17(a)(2) requires, Duka 'obtain[ed] money or property' by means of the misstatements and omissions in the 2011 Presales.").

[54] The remaining engagement letters and presales followed a similar pattern. *See* Joint Exs. 29 (FREMF 2011-K701 engagement letter signed December 2, 2010), 30 (FREMF 2011-K701 presale issued February 15, 2011), 36 (JPMCC 2011-C3 engagement letter signed December 10, 2010), 37 (JPMCC 2011-C3 presale issued February 18, 2011), 45 (FREMF 2011-K11 engagement letter signed December 22,

The Division argues that the engagement letters show that S&P received fees in exchange for rating the issuers' CMBS transactions and adds that the issuers used the presales in marketing and selling their bonds. Div. Response Br. at 3. Both of these points are accurate as far as they go. But these facts do not mean that S&P obtained money "*by means of*" the statements or omissions *in the presales*. Instead, the issuers obligated themselves well before the alleged misstatements or omissions in the presales for those transactions ever existed. Indeed four of the engagement letters were signed before the first relevant presale was created. *Compare* Joint Exs. 21, 29, 36, 45, *with* Joint Ex. 22. At least on the record in this case, S&P cannot have obtained money by means of a statement or omission that did not yet exist.[55]

Perhaps the Division could have argued that the issuers who signed engagement letters after February 2011 were generally relying on what they had seen in the first three or four 2011 presales in deciding to engage S&P, but the Division does not advance this argument. And except to elicit testimony very generally describing the process by which issuers engage rating agencies, *see* Tr. 422-35, the Division presented no evidence as to what induced the issuers of the eight transactions to engage S&P or how or whether Duka was involved in that initial process.

Section 17(a)(3). In determining whether Duka negligently "engage[d] in any transaction, practice, or course of business which operate[d] or would [have] operate[d] as a fraud or deceit upon [a] purchaser," 15 U.S.C. § 77q(a)(3), the question is whether Duka "failed to exercise reasonable care" and thereby caused investors to "receive misleading information" about the issuers' transactions or somehow "prevented [investors] from learning material information about" those transactions, *Dennis J. Malouf*, 2016 WL 4035575, at *11 n.74, *12. Answering the question of whether there was a misleading omission is more complicated here than usual. As Adelson readily admitted, the criteria article is "lousy" and "leaves something to be desired" in terms of whether S&P would use Table 1 constants to

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2010), 46 (FREMF 2011-K11 presale issued March 15, 2011), 52 (FREMF 2011-K13 engagement letter signed March 10, 2011), 53 (FREMF 2011-K13 presale issued May 9, 2011), 59 (JPMCC 2011-C4 engagement letter signed March 31, 2011), 60 (JPMCC 2011-C4 presale issued May 17, 2011), 67 (GSMS 2011-GC4 engagement letter signed May 10, 2011), 68 (GSMS 2011-GC4 presale issued July 12, 2011), 76 (FREMF 2011-K14 engagement letter signed May 4, 2011), 77 (FREMF 2011-K14 presale issued July 18, 2011).

55 For this reason, the Division also cannot show that S&P committed a primary violation of Securities Act Section 17(a)(2), meaning the Division's alternative argument—that Duka caused such a violation, OIP ¶ 50, Div. Posthearing Br. at 31 n.29—fails. *Robert M. Fuller*, Securities Act Release No. 8273, 2003 WL 22016309, at *4 (Aug. 25, 2003).

rate transactions. Tr. 365, 370. Indeed, the article does not say that Table 1 constants would be used to rate actual, real world transactions. Rather, the fact that Table 1 constants were supposed to serve as a "benchmark" suggests that actual transactions would be judged against the Table 1 constants in some fashion rather than using them. And, as Duka's counsel ably demonstrated, if one looked at Table 6 of the criteria article and used a calculator, one would learn that the information conveyed in that table was based on actual constants rather than Table 1 constants. Tr. 105-09. Given the confusing nature of the criteria article, it is a not a useful reference, by itself, for judging whether the presales were misleading.

On the other hand, even if one believes, as Duka does, Resp. Posthearing Br. at 30-31, Resp. Responsive Br. at 4, that the criteria article called for the use of actual constants, the fact remains that none of the eight transactions were rated using actual or Table 1 constants. They were rated using blended constants, a fact not disclosed.

The presales, however, suggest the use of Table 1 constants. For example, the presale for the Morgan Stanley deal provided that:

> The transaction has a weighted average DSC of 1.20x based on a Standard & Poor's loan constant of 8.46%, which is in line with the archetypical pool. Standard & Poor's DSCs range from 0.94x to 1.57x and are based on stressed loan constants ranging from 8.25% to 10.00%, depending on the property type.

Joint Ex. 22 at 5. This language is seemingly based on Table 1. *See* Joint Ex. 2 at 5; *see also* Joint Ex. 5 at 5-6. Reference to S&P's "loan constant of 8.46%," Joint Ex. 22 at 5, 7, "a weighted average stressed Standard & Poor's loan constant of 8.46%," *id.* at 8, "Debt service coverage (based on Standard & Poor's constant)," *id.* at 22, or "Standard & Poor's stressed constant of 8.25%," *id.* at 23, 28, 33, 52, 57, 61, 66, are also found in the presale. These references also suggest reliance on Table 1 constants. For example, Table 1 provides an 8.25% loan constant for retail and office properties. Joint Ex. 2 at 5. Further indications of Table 1 constants include use of "Standard & Poor's stressed constant[s]" that correspond to additional property types listed in Table 1. *Compare* Joint Ex. 22 at 38 (8.50%), 44 (8.5%), 47 (10%), *with* Joint Ex. 2 at 5 (8.50% and 10% loan constants for industrial and lodging properties, respectively). And it bears noting that in 2010, when it rated a transaction for which it was not retained, S&P said (1) it was rating the transaction to inform the market of its views, and (2) it would use its Table 1 "stressed constants" to evaluate transactions. Div. Ex. 230 at 1, 4 (of paginated pages). Finally, the presale repeatedly differentiates between S&P's stressed constant and actual constants. *Id.* at 18, 23, 28, 33, 38, 47, 57, 61, 66.

Despite the suggestion that Table 1 constants would be used to rate transactions, and as detailed above, the eight CMBS transactions at issue were rated using blended constants. The presales, however, do not mention the use of blended constants. Tr. 1231. The closest the presales come to disclosing the use of blended constants is the language cited by Duka that:

> In determining a loan's DSC, Standard & Poor's will consider both the loan's actual debt constant and a stressed constant based on property type as further detailed in our conduit/fusion criteria.

E.g., Joint Ex. 22 at 18. This disclosure is "literally true," *IFG Network Sec., Inc.*, Advisers Act Release No. 2533, 2006 WL 1976001, at *10 (July 11, 2006), insofar as calculations based on blended constants involve consideration of both actual and stressed constants. But in light of the indications that the pools would generally be rated using Table 1 constants, this statement "presented an incomplete picture," *id.*, because new issuance was not vaguely "consider[ing] both" the actual and stressed constants; it was averaging the two, *see* Tr. 1232 (conceding that this language only "partially complied" with her agreement with Parisi). S&P thus omitted information in the presale.

The next question is whether this omission was material.[56] Materiality turns on "whether a *reasonable* investor would have viewed the [un]disclosed information 'as having significantly altered the 'total mix' of information made available."[57] Because this test is objective, *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976), "the reaction of individual investors is not determinative of materiality," *Richmark Capital Corp.*, Securities Act Release No. 8333, 2003 WL 22570712, at *5 (Nov. 7, 2003). That reaction, however, is relevant.

The Division says that the undisclosed use of blended constants is material because the switch to blended constants resulted in a dramatic change in credit

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56 *Cf. IFG Network Sec., Inc.*, 2006 WL 1976001, at *12 (holding that the negligent omission of material information constituted violations of Section 17(a)(2) and (3)); *Byron G. Borgardt*, Securities Act Release No. 8274, 2003 WL 22016313, at *10, *13 (Aug. 25, 2003) (holding that respondent caused violations of Section 17(a)(2) and (3) by omitting material facts).

57 *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 44 (2011) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988)); *see Timothy S. Dembski*, Securities Act Release No. 10326, 2017 WL 1103685, at *8 (Mar. 24, 2017) ("A misstatement or omission is material if 'there is a substantial likelihood that it would be perceived as important by a reasonable investor.'" (citation omitted)).

enhancement levels from the levels that S&P would have calculated using Table 1 constants. Div. Prehearing Br. at 14; Div. Posthearing Br. at 9, 22-23. For seven of the eight transactions, the change was between 437 and 750 basis points, amounting to a reduction of between 25% and 55%. Div. Posthearing Br. at 9; *see* Div. Ex. 335 at 48-50. For one transaction, there would have been no change.[58] These transactions would have received lower ratings using Table 1 constants as compared to blended constants. Div. Ex. 335 at 48-50. This means that the transactions would have required additional credit enhancement, meaning less AAA-rated bonds could be sold to investors.

Duka argues that the change could not be material because CMBS investors are sophisticated institutions that perform their own due diligence and are unconcerned about the specific metrics S&P employed. Resp. Posthearing Br. at 6-7. Essentially, Duka complains that the Division is attempting to define materiality too generally while the Division says Duka is trying to be too specific. The Division has the better of this argument. Investors might not have cared about the specific metrics but they cared, some more than others, about the final rating, even if they only viewed the rating as a sanity check. *See* Tr. 1989. Given the correlation between constants and ultimate ratings, a reasonable investor would view it as important that, whereas an undisclosed constant was used and yielded higher reported ratings, the disclosed constant was not used and would potentially have yielded different ratings that were not disclosed.

Anecdotal evidence supports this determination. For instance, Penner opined that CMBS investors use loan constants to measure the borrower's ability make debt payments. Tr. 701. Weih testified that Aegon would not buy any CMBS conduit transaction rated under AAA for various portfolios. Tr. 874-75. And Peterson both tried to understand rating agencies' ratings methodology and said Principal's investment decisions are limited by how far below AAA a client would permit Principal to invest. Tr. 1033-34, 1037-38. It is thus likely that a reasonable investor would have viewed S&P's omission as important. Duka's omission was therefore material. *See Timothy S. Dembski*, 2017 WL 1103685, at *8.

This brings us to the ultimate question: whether Duka failed to exercise reasonable care. Duka understood that Parisi's approval of the use of blended constants was conditioned on that use being disclosed in presales and RAMPS. Tr. 1140, 1517. Duka agreed to do so. Tr. 1142, 1473-74. But Duka never told anyone about her agreement with Parisi or the need to comply with it. She also never

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[58] Oddly enough, the one transaction for which using blended constants did not change the credit enhancement levels was FREMF 2011-K14, *see* Div. Ex. 335 at 38 n.96, 50 & n.137, one of the two transactions for which S&P withdrew its rating, Resp. Ex. 679.

verified that the use of blended constants was fully disclosed. Given these failures, it is hardly surprising that they were not fully disclosed.

And Duka admitted that she fell down on her responsibility. When asked, Duka agreed that she "could have said something clearer about actually using a 50/50 blend in the pre-sale." Tr. 1230. Duka also conceded that Pollem's language in the presale only "partially complied" with her agreement with Parisi. Tr. 1232.

Whether Duka was normally responsible for reviewing presales is not relevant. She agreed as a condition of using blended constants to ensure that use was disclosed. Duka failed to live up to her end of that agreement.

Whether a person acted negligently—whether the person failed to act with reasonable care—depends on the context in which the person acted or failed to act. *See KPMG Peat Marwick LLP*, Exchange Act Release No. 43862, 2001 WL 47245, at *20 (Jan. 19, 2001), *recons. denied*, Exchange Act Release No. 44050, 2001 WL 223378 (Mar. 8, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002). Here, S&P had not previously used blended constants. It had not previously announced that it might use blended constants. Investors would have had no reason to even guess S&P might use blended constants. Yet after receiving permission to use blended constants and promising to disclose that use in the presales, Duka never told any of her subordinates to include that information in the presales and never confirmed that it was included. And when asked to approve language regarding the use of blended constants, she approved language that inadequately disclosed S&P's methodology.

In this context, Duka's failure to ensure that the use of blended constants was disclosed, after she voluntarily accepted the responsibility to ensure that disclosure, reflected a lack of reasonable care because the potential harm resulting from that failure was predictable. This is especially the case because Duka was specifically asked to approve Pollem's language concerning the issue.[59] *See Byron G. Borgardt*, 2003 WL 22016313, at *10 ("In failing to see that appropriate disclosures were made, Respondents were negligent."). Duka failed to act with reasonable care and was therefore negligent. And her negligence caused "investors [to] receive misleading information" and "prevented [them] from learning material information." *Dennis J. Malouf*, 2016 WL 4035575, at *12. Because Duka's negligence extended to eight presales that omitted material information, her actions

59 At common law, one who voluntarily assumes a duty is responsible for acting with due care in carrying out that assumed duty. *See Hartford Steam Boiler Inspection & Ins. Co. v. Pabst Brewing Co.*, 201 F. 617, 633 (7th Cir. 1912); *see also Noonan Const. Co. v. Fed. Barge Lines, Inc.*, 453 F.2d 637, 640 (5th Cir. 1972); *Rogers v. United States*, 397 F.2d 12, 14 (4th Cir. 1968); *Robinson v. Ne. Steamship Corp.*, 228 F.2d 679, 681 (2d Cir. 1956).

amounted to a "practice[] or course of business which operate[d] . . . as a fraud or deceit upon [a] purchaser."[60] 15 U.S.C. §77q(a)(3).

2.2. The alleged violations of Exchange Act Rules 17g-2 and 17g-6 and Exchange Act Section 15E(c)(3)

The Division argues that Duka aided and abetted, and caused S&P's violations of Exchange Act Rules 17g-2(a)(6) and 17g-6(a)(2) and Exchange Act Section 15E(c)(3). To demonstrate aiding and abetting liability, the Division must show (1) a primary violation; (2) knowledge or awareness by Duka of the primary violation; and (3) Duka's substantial assistance in the commission of the primary violation. *Mohammed Riad*, 2016 WL 3627183, at *17 n.41. Showing recklessness is sufficient to satisfy the knowledge or awareness requirement. *Id.* A person "who aids and abets a primary violation is necessarily a cause of that violation." *Id.*

To establish liability for causing a violation, the Division must similarly show: (1) a primary violation; (2) an act or omission by Duka that caused the violation; and (3) that Duka knew, or should have known, that her conduct would contribute to the violation. *Robert M. Fuller*, 2003 WL 22016309, at *4. Negligence is enough to demonstrate causing liability if the primary violation does not require a showing of scienter. *KPMG Peat Marwick LLP*, 2001 WL 47245, at *19.

At the outset, I reject the suggestion that, because S&P settled allegations against it in a separate matter, the Division has established a primary violation in this matter. *See* Div. Posthearing Br. at 24 & n.25. The findings announced under that settlement do not bind Duka. *See Standard & Poor's Rating Services*, 2015 WL 252448, at *1 n.1; *see also Rodney R. Schoemann*, 2009 WL 3413043, at *13 n.55 ("settlements can be reached for any number of reasons[] and . . . are not precedent"). The Division must therefore independently establish the primary violations underlying the aiding and abetting and causing violations it has alleged.

2.2.1. Duka did not aid and abet or cause a violation of Rule 17g-2(a)(6)

Congress passed the Credit Rating Agency Reform Act of 2006 in an effort to improve the quality of ratings issued by rating agencies. S. Rep. 109-326, at 1 (2006). The Act added a new Section 15E to the Exchange Act and imposed certain application requirements on any credit rating agency wishing to be treated as a nationally recognized statistical rating organization. *See* Pub. L. 109-291, § 4(a), 120 Stat. 1327, 1329-31 (codified at 15 U.S.C. § 78*o*-7). As is relevant to this proceeding, the Act required that an agency's application "contain information regarding . . . the

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60 The fact that the use of blended constants happened not to "move" the credit enhancement levels for FREMF 2011-K14 does not render the omission immaterial. *See SEC v. DCI Telecommunications, Inc.*, 122 F. Supp. 2d 495, 499 (S.D.N.Y. 2000).

procedures and methodologies that the [agency] uses in determining credit ratings." *Id.*; *see* 15 U.S.C. § 78*o*-7(a)(1)(B)(ii). The Act imposed a requirement on the Commission to either grant the application or institute proceedings to determine whether it should be denied. *See* 15 U.S.C. § 78*o*-7(a)(2)(A). The Act empowered the Commission to deny an application if the rating agency lacks the "resources . . . to materially comply with the procedures and methodologies" disclosed in the agency's application. 15 U.S.C. § 78*o*-7(a)(2)(C)(ii)(I).

After passage of the Credit Rating Agency Reform Act, the Commission promulgated Exchange Act Rule 17g-2. *See* Oversight of Credit Rating Agencies, Exchange Act Release No. 55857, 2007 WL 1624609, at *35-50 (June 5, 2007). Rule 17g-2 imposes on rating agencies certain recordkeeping requirements designed to ensure compliance with Section 15E. *Id.* at *35. Among other requirements, the rule mandates, consistent with Exchange Act Section 15E(a)(1)(B)(ii), that a rating agency internally maintain a complete and current "record documenting the *established* procedures and methodologies used by the nationally recognized statistical rating organization to determine credit *ratings*." 17 C.F.R. § 240.17g-2(a)(6) (emphasis added); *see* 2007 WL 1624609, at *40.

In a motion for summary disposition and reply to Duka's opposition to the motion, the Division asserted that Duka aided and abetted S&P's violation of Rule 17g-2(a)(6) by failing to document in the RAMPs the use of blended constants. In its initial motion, it argued that:

> By failing to explain and make an accurate record of the rating recommendations in the RAMPs as required by the RAMP Guidelines, and failing to describe and document in the RAMPs key assumption[s] used in and modifications made to models as required by the Model Use Guidelines, S&P failed to maintain complete and current books and records documenting established procedures and methodologies used to determine credit ratings.

Div. Mot. at 26. In reply to Duka's opposition, the Division asserted that "[t]he RAMP is . . . an integral and critical part of S&P's procedures to ensure criteria is followed. As such, it should be and is covered by Rule 17g-2(a)(6)." Div. Reply at 17.

In its prehearing brief, the Division asserted that "Duka's surreptitious change in loan constants used by S&P to rate CMBS transactions was, in effect, an improper amendment to S&P's CMBS ratings methodology without following S&P mandated procedures for making and documenting the change." Div. Prehearing Br. at 21.

In its posthearing brief, the Division argues that S&P violated Rule 17g-2(a)(6) in two ways. Div. Posthearing Br. at 26. It reiterates the RAMP-based aspect of its argument, asserting that S&P failed "to document the use of blended constants in the RAMPs for the eight CMBS transactions rated by Duka's team in 2011." *Id.* It adds that S&P also failed "to document the switch to blended constants as a significant modification of the 2009 Criteria." *Id.* The Division apparently believes Duka aided and abetted these violations by failing to follow the criteria process guidelines, which, had she done so, would have led to the change being documented "both through a criteria article or other general description of the use of blended constants, and in the RAMP[s]." *Id.* at 27. The Division is ambiguous about whether it views the criteria and RAMP documentation failures as simply results of Duka's failure to follow the guidelines, or rather, as additional independent failures on the part of Duka. *Id.*; Div. Response Br. at 21. That distinction, however, is immaterial for purposes of my analysis.

The Division is mistaken to premise a Rule 17g-2(a)(6) violation on the documentation failures in the RAMPs. Section 15E and Rule 17g-2(a)(6) make plain that the term *procedures and methodologies* refers to procedures and methodologies that are generally applicable, *i.e.*, those that are "established." 15 U.S.C. § 78*o*-7(a)(1)(B)(ii); 17 C.F.R. § 240.17g-2(a)(6). Indeed, the rule applies to procedures and methodologies used "to determine . . . *ratings*" not used to determine a specific *rating*. *See* Oversight of Credit Rating Agencies, 2007 WL 1624609, at *38 (dispensing with a rating-specific recordkeeping requirement in favor of a requirement to maintain a record of "procedures and methodologies it uses to determine credit ratings"). And because the procedures and methodologies must be included in the rating agency's initial application, *see* 15 U.S.C. § 78*o*-7(a)(1)(B)(ii), the contemplated procedures and methodologies would exist before any rating is issued and thus cannot be tied to any specific rating.

As Duka argues, in promulgating Rule 17g-2(a)(6), the Commission initially proposed requiring rating agencies to maintain "[r]ecords with respect to each of the rating organization's current credit ratings indicating . . . [t]he procedures and methodologies used to determine the rating." Oversight of Credit Rating Agencies, Exchange Act Release No. 55231, 2007 WL 325688, at *79 (Feb. 2, 2007); *see* Resp. Posthearing Br. at 41-42. In the final adopting release, the Commission jettisoned this requirement in favor of a more general requirement to "document the procedures and methodologies it uses to determine credit ratings." Oversight of Credit Rating Agencies, 2007 WL 1624609, at *38. And instead of mandating the public release of "each procedure and methodology," the Commission required agencies to internally maintain "a description of [its] procedures and methodologies." *Id.* at *40. The Commission expressly stated that "examiners will not need an individual record identifying the methodology used to determine each credit rating." *Id.* at *38.

The Division is therefore mistaken that, by failing to document in the RAMPs the use of blended constants or by failing to follow criteria process guidelines (which led to such RAMP documentation failures), Duka caused S&P's violation of Rule 17g-2(a)(6). While the RAMPs were specific to each transaction, the rule pertains to established procedures and methodologies rather than to specific transactions.

The Division is also mistaken to premise the asserted Rule 17g-2(a)(6) violation on a published criteria article. The Commission made clear in promulgating Rule 17g-2(a)(6) that the rule pertains to procedures and methodologies that are "documented internally." Oversight of Credit Rating Agencies, 2007 WL 1624609, at *40. Indeed, the rule was "designed to avoid" burdens associated with public disclosure. *Id.* Accordingly, a published criteria article or "other general description" does not fall within the rule's terms and therefore cannot by itself serve as a basis for a violation.

Moreover, the purported failure by Duka to follow the criteria process guidelines—which the Division asserts is the cause of the RAMP and criteria documentation failures, Div. Posthearing Br. at 27—is not supported by the evidence. In fact, Duka followed the guidelines insofar as she raised the blended constants issue with Parisi, the acting criteria officer, as the guidelines required. It is true that Duka failed to adequately document the switch to blended constants in the RAMPs and the presales, as she agreed. But, as already noted, Rule 17g-2(a)(6) is not aimed at such transaction-specific documents. Oversight of Credit Rating Agencies, 2007 WL 1624609, at *38.

Further, the evidence shows that the switch to blended constants was an interpretation and thus not a criteria change subject to the criteria change process guidelines. *See* Resp. Ex. 589 at 1; Joint Ex. 8 at 1-2; Tr. 646. But even assuming the switch was more than an interpretation, the responsibility to document a programmatic change rested, by the terms of the criteria process guidelines, with Parisi and Geramian, who were criteria officers. Joint Ex. 10 at 12-13, 17. Duka, therefore, did not aid and abet or cause a violation of Rule 17g-2(a)(6).

2.2.2. Duka did not aid and abet or cause a violation of Rule 17g-6(a)(2)

Exchange Act Section 15E also required that the Commission issue rules "prohibit[ing] any act or practice . . . by a nationally recognized statistical rating organization that the Commission determines to be unfair, coercive, or abusive, including any act or practice" set forth in Section 15E(i)(1)(A) through (C). 15 U.S.C. § 78*o*-7(i)(1)(A)-(C); Oversight of Credit Rating Agencies, 2007 WL 1624609, at *67. Among the acts or practices subject to this rulemaking requirement were those that relate to:

> modifying or threatening to modify a credit rating or otherwise departing from its adopted systematic procedures and methodologies in determining credit ratings, based on whether the obligor, or an affiliate of the obligor, purchases or will purchase the credit rating or any other service or product of the nationally recognized statistical rating organization or any person associated with such organization.

15 U.S.C. § 78*o*-7(i)(1)(C).

Based on this congressional directive, the Commission promulgated Exchange Act Rule 17g-6(a)(2). *See* Oversight of Credit Rating Agencies, 2007 WL 1624609, at *69-70. This rule bars:

> [i]ssuing, or offering or threatening to issue, a credit rating that is not determined in accordance with the nationally recognized statistical rating organization's established procedures and methodologies for determining credit ratings, *based on* whether the rated person . . . purchases or will purchase the [organization's] credit rating.

17 C.F.R. § 240.17g-6(a)(2) (emphasis added). As explained by the Commission, a rating agency would violate this rule by issuing or threatening to issue a lower rating than that called for by its methodology based on whether the issuer pays for the rating—punishing the issuer if it did not pay for the rating. Oversight of Credit Rating Agencies, 2007 WL 1624609, at *69 & n.411. A rating agency would also violate the rule by "issuing or promising to issue a higher credit rating" based on whether the issuer pays for the rating—rewarding the issuer if it did pay for the rating. *Id.* As the Division puts it, Rule 17g-6(a)(2) "prohibits [rating agencies] from altering ratings methodologies to attract business." Div. Posthearing Br. at 24.

The Division asserts S&P violated Rule 17g-6(a)(2) by switching to blended constants in order to attract business. Div. Posthearing Br. at 25-26. It argues that because Duka directed this switch to blended constants based on a commercial motive, she contributed to or caused S&P's violation of Rule 17g-6(a)(2). *Id.* at 26. As discussed above with respect to the antifraud allegations, there is no evidence that Duka or anyone else at S&P switched to using blended constants for the purpose of attracting business. Instead, new issuance sought and received permission to use blended constants for analytical reasons. Duka and her staff in new issuance used blended constants because they did not believe that using Table 1 constants made analytical sense. Even assuming the switch to blended constants resulted in ratings "not determined in accordance with" S&P's "established procedures and methodologies," there is no evidence the decision to switch was "based on" the desire to induce issuers to engage S&P. The Division has thus failed to establish a primary violation of Rule 17g-6(a)(2). It follows that the Division cannot show that Duka aided and abetted or caused S&P's violation of this rule.

2.2.3. Duka caused S&P's violation of Section 15E(c)(3)

In 2010, Congress added a new subsection (c)(3) to Exchange Act Section 15E. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 932(a)(2)(B), 124 Stat. 1376, 1873. Subsection (c)(3)(A) provides that:

> Each nationally recognized statistical rating organization shall establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the Commission may prescribe, by rule.

15 U.S.C. § 78*o*-7(c)(3)(A). This requirement was "self-executing" and effective the day after the Dodd-Frank Act was enacted. Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 72936, 2014 WL 4538057, at *30 (Aug. 27, 2014); *see* Dodd-Frank Act, Pub. L. 111-203, § 4, 124 Stat. 1390.

In moving for summary disposition, the Division argued, in part, that S&P violated this provision when Hu, on behalf of the model quality review group, reviewed an outdated model. Div. Mot. at 25. It argued that Duka aided and abetted and caused this violation by changing the model and "being obtuse in her answers to" Hu's inquiries. *Id.* It also argued that Duka's failure to comply with guidelines and her broken promise to Parisi constituted aiding and abetting S&P's violation. *Id.*; Div. Reply at 14.

In its prehearing brief, the Division added that "S&P undermined its own internal control structure" by allowing Duka to influence the criteria she was implementing. Div. Prehearing Br. at 20. The Division did not attempt to define the nature of S&P's internal control structure. *See id.*

In its posthearing brief, the Division asserts that S&P's internal controls included its code of conduct, criteria process guidelines, model quality control group, and RAMP documentation. Div. Posthearing Br. at 15-16, 27 n.27. It also notes ways "S&P's internal controls may have been undermined," before arguing that S&P rendered its internal control structure ineffective by "putting Duka in a position to both modify the 2009 Criteria and evade S&P's internal controls"—*i.e.*, S&P committed a primary violation by putting Duka in charge of CMBS. *Id.* at

28-29. And by reference to section II.E of the facts section of its brief, the Division seems to claim that Duka "failed to maintain and enforce [S&P's] internal controls" by her alleged scheme involving her meeting with Parisi. *Id.* at 9-11, 29. It thus argues that "Duka was at least negligent in causing S&P's failure to maintain and enforce its internal controls" because she hid the change from model quality review, did not follow criteria process guidelines, and failed to ensure the switch to blended constants was documented and disclosed. *Id.* at 29. In response to Duka's posthearing brief, the Division argues that "Duka's scheme exposed the ineffectiveness of S&P's internal [model quality review], Quality, and Criteria controls that failed to detect her conduct, and caused S&P to issue ratings that were not consistent with the 2009 Criteria, leading to the withdrawal of two preliminary ratings." Div. Response Br. at 21.

The Division's assertion that S&P undermined its internal controls by placing Duka in her position does not support any aiding and abetting or causing liability as to Duka because the Division presented no evidence that Duka substantially assisted or contributed to S&P's decision to put her in this position or delineate the powers accompanying that position.

As noted, however, the Division mainly contends that the primary violation was S&P's failure to maintain and enforce its relevant internal controls—the criteria process guidelines, the model quality review group, RAMP documentation, and the code of conduct. Div. Posthearing Br. at 15-16, 27 n.27, 29. But I have already determined that Duka followed the criteria process guidelines by raising the switch to blended constants with Parisi. As to model quality review, there is no evidence that Duka had responsibility to ensure Hu had the correct model, and Duka even took steps to ensure that she accurately explained new issuance's model to Hu. Further, the Division does not explain how RAMP documentation served as a control rather than simply a record of how ratings were determined. *See* Tr. 770, 1207. When Milano was asked about written documents that "governed . . . internal control[] functions," he did not mention the transaction-specific RAMPs but instead referred to the code of conduct, as well as "policies" and "guidelines" that offer "more procedural guidance on how to comply with the policies." Tr. 218. Indeed, consistent with this testimony, it appears the actual internal control governing how RAMP documentation was carried out was the model use guidelines issued by the policy governance group. *See* Div. Ex. 196 at 1, 5.

This leaves the code of conduct, which Milano said was an internal control. Tr. 218. He also affirmed that S&P personnel had been disciplined for violating the code of conduct. Tr. 211. Among its 17 pages, the code of conduct provides that "[w]here Ratings Services assigns an initial rating to a structured finance product, it shall provide investors and/or subscribers (depending on Ratings Services business model) with a brief statement of its analytic rationale." Div. Ex. 269 at 10; *see* OIP ¶ 9.

Given the requirements of the code of conduct and the omissions in the presales, the questions are (1) whether S&P's publication of ratings that did not fully disclose the use of blended constants violated the code of conduct, and (2) if so, whether those violations of the code of conduct mean that S&P failed to "maintain[or] enforce . . . an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings." 15 U.S.C. § 78o-7(c)(3)(A).

The answer to the first question is yes. Under the code of conduct, when providing a rating, S&P was required to give investors "a brief statement of its analytic rationale." Div. Ex. 269 at 10. S&P failed to do this—it did not accurately provide "its analytic rationale," briefly or otherwise—because its presales did not disclose the use of blended constants and instead suggested the use of Table 1 constants. Had S&P used Table 1 constants, as its presales suggested, seven of the transactions would have been rated differently.

The second question comes down to whether S&P's publishing a presale that did not comply with an internal control means the company failed to maintain and enforce an effective internal control structure. Answering yes, on the one hand, might suggest that S&P was required to maintain a perfect, rather than effective, internal control structure. It might also mean that every failure to adhere to internal controls is proof the control structure was not maintained or enforced. Neither of these suggestions is consistent with the spirit of the statute. On the other hand, multiple undetected violations of internal controls might sufficiently show that those controls were not maintained or enforced.

The issue here falls into the latter category. All eight of the CMBS presales S&P published from February to July 2011 omitted the fact that blended constants were used and instead suggested that Table 1 constants were used. All eight failed to comply with the analytic rationale requirement in the code of conduct. These consistent and repeated failures show that S&P failed to maintain and enforce an effective internal control structure and constitute a violation of Exchange Act Section 15E(c)(3)(A).[61]

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[61] Nothing in the language of Section 15E(c)(3)(A) suggests an intent requirement for finding a violation; rather, it conveys, without reference to intent, a positive command to take certain action. *See* 15 U.S.C. § 78*o*-7(c)(3)(A); *SEC v. Wills*, 472 F. Supp. 1250, 1268 (D.D.C. 1978) (finding that Exchange Act Sections 13(a) and 14(a) do not require a showing of scienter because neither "gives [a] hint that intentional conduct need be found, but rather, appear[] to place a simple and affirmative duty of reporting on certain persons" (quoting *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1166-1167 (D.C. Cir. 1978))).

Given S&P's primary violation of Section 15E(c)(3)(A), the issue is whether Duka is liable for causing the violation.[62] Negligence is sufficient to support a charge that a respondent caused such a violation. *See KPMG Peat Marwick LLP*, 2001 WL 47245, at *19. Duka's negligent failure to ensure that the presales disclosed the use of blended constants, after telling Parisi she would do so, was a cause of S&P's violation.[63] And Duka should have known that, by making this promise and then not following through, the disclosure failure would occur. She is therefore liable for having caused S&P's violation.

Duka argues that she cannot be secondarily liable for violating subsection (c)(3)(A) by allegedly having "circumvented" S&P's internal controls. Resp. Posthearing Br. at 37-38. In support of this argument, she asserts that the subsection is similar to the internal controls provision of Exchange Act Section 13(b)(2), except that Congress specifically prohibited circumvention of such controls in Section 13(b)(5). Because Section 13(b) contains an express circumvention prohibition, Duka thinks Congress's omission of one in Section 15E(c) must mean that Congress did not intend for there to be secondary liability for circumvention of internal controls under the latter provision.

Duka's argument, a variant of the canon that the expression of one thing is the exclusion of others, might have some force if Section 15E(c) and Section 13(b)(5) had been enacted at the same time. At least in that circumstance, she would have a plausible argument that Congress had the possibility of an express circumvention provision in mind when it passed Section 15E(c). But Congress added paragraph (5) to Section 13(b) in 1988, 22 years before it added subsection (c)(3) to Section 15E in the 2010 Dodd-Frank Act. *See* Omnibus Trade and Competitiveness Act of 1988, Pub. L. 100-418, § 5002, 102 Stat. 1107, 1415. The inclusion of an express circumvention provision in Section 13(b)(5) therefore does not mean that a respondent cannot be liable for causing a violation of Section 15E(c)(3)(A) by circumvention.[64] Accordingly, I reject Duka's argument that she cannot be

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[62] The Division did not show that Duka acted with scienter or extreme recklessness. It therefore cannot show that Duka aided and abetted S&P's violation of Section 15E(c)(3)(A).

[63] To be sure, it was not the only cause. The analysts' recycling of previous presales for use as templates also contributed to this violation.

[64] *See Lindh v. Murphy*, 521 U.S. 320, 330 (1997) ("negative implications raised by disparate provisions are strongest when the portions of a statute treated differently had already been joined together and were being considered simultaneously when the language raising the implication was inserted"); *cf. Marx v. Gen. Revenue Corp.*, 133 S. Ct. 1166, 1175 (2013) ("the *expressio unius* canon does not apply 'unless it is fair to suppose that Congress considered the unnamed

secondarily liable for violating Section 15E(c)(3)(A) by circumventing S&P's internal controls.[65]

3. Sanctions

The Division asks that I impose on Duka a cease-and-desist order, unspecified third-tier monetary penalties, and a bar from certain capacities in the securities industry. Div. Posthearing Br. at 41-43. Because there is no evidence Duka was enriched, unjustly or otherwise, the Division does not seek disgorgement.

3.1. Cease-and-desist order

Section 8A(a) of the Securities Act and Section 21C(a) of the Exchange Act authorize the Commission to issue a cease-and-desist order against a person who "is violating, has violated, or is about to violate" any provision of or rule under the Securities Act and Exchange Act, respectively. 15 U.S.C. §§ 77h-1(a), 78u-3(a). These statutes also allow the imposition of a cease-and-desist order against any person "that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation." 15 U.S.C. §§ 77h-1(a), 78u-3(a). In deciding whether to issue a cease-and-desist order, I must consider: (1) whether future violations are reasonably likely; (2) the seriousness of the violations at issue; (3) whether the violations are isolated or recurrent; (4) Duka's state of mind; (5) whether Duka recognizes the wrongful nature of her conduct; (6) the recency of her violations; (7) "whether the violations caused harm to investors or the marketplace"; (8) "whether [Duka] will have the opportunity to commit future violations"; and (9) "the remedial function [a] cease-and-desist order would serve in the overall context of any other sanctions sought in [this] proceeding." *Gordon Brent Pierce*, Securities Act Release No. 9555, 2014 WL 896757, at *23 (Mar. 7, 2014), *pet. denied*, 786 F.3d 1027 (D.C. Cir. 2015); *see KPMG Peat Marwick LLP*, 2001 WL 47245, at *26.

"[T]he showing of risk of future violations" necessary to warrant a cease-and-desist order is "significantly less than that required for an injunction." *KPMG Peat Marwick LLP*, 2001 WL 223378, at *6 (denying reconsideration). As a result, that which the Division must show "need not be very great to warrant issuing a cease-

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possibility and meant to say no to it'") (quoting *Barnhart v. Peabody Coal Co.*, 537 U.S. 149, 168 (2003)).

[65] Based on Commission precedent, I also reject Duka's argument that this proceeding violates the Appointments Clause of the Constitution. Resp. Posthearing Br. at 42; *see Harding Advisory LLC*, Securities Act Release No. 10277, 2017 WL 66592, at *19 & nn.82, 90 (Jan. 6, 2017), *pet. for review filed*, No. 17-1070 (D.C. Cir. Mar. 6, 2017).

and-desist order." *Id.* Indeed, "in the ordinary case and absent evidence to the contrary, a finding of past violation raises a sufficient risk of future violation." *Id.* A cease-and-desist order does not automatically follow, however, a determination of a past violation. *Id.* at *7. Only after considering the other factors should a cease-and-desist order be imposed. *Id.*

Other than noting the rule from *KPMG Peat Marwick* that a risk of future violations can normally be shown solely by the fact of a past violation, the Division makes no argument as to why a cease-and-desist order is warranted. This is significant because this case involves a negligent omission which does not strongly suggest the risk of a future violation. *See Moneta Fin. Servs., Inc.*, Advisers Act Release No. 2438, 2005 WL 2453949, at *2 (Oct. 4, 2005) (declining to issue a cease-and-desist order).

Left to my own devices, I conclude that Duka's violations were serious. Duka assumed a duty to ensure adequate disclosure concerning the use of blended constants. Her failure to take any steps to follow through on her assurance to Parisi directly contributed to the relevant omissions in the presales.

The violations were not isolated in that there were eight presales and each one omitted the same material information. On the other hand, the violations occurred eight times in a six-month span, six years ago. There is no evidence they have been repeated since 2011. Duka did not act with scienter and did not act with the intent to harm or defraud anyone. I cannot say definitively whether she recognizes the wrongfulness of her omission, but she somewhat attempted during her testimony to shift responsibility for the disclosure onto others rather than herself. Tr. 1473-74. She did, however, recognize that the presales could have been more informative regarding the use of blended constants.

S&P's decision to withdraw the two ratings in July 2011 caused disruption and uncertainty in the market. Tr. 542, 906-07, 909-10. Issuers were harmed because they were forced to make investors whole. Tr. 906, 908-09; *see* Tr. 547-48. And S&P's reputation suffered. Tr. 547-48, 907, 2107. But whether Duka's omission caused these things is not clear. S&P's republished presales had the same ratings as those in the withdrawn presales, and S&P affirmed that the original ratings were consistent with the criteria article. This raises the possibility that withdrawing the ratings was unnecessary and therefore that S&P's decision to withdraw, not Duka's omission, caused the disruption in the market and harm to S&P's reputation and to issuers.

Finally, the context of the other sanctions discussed below supports imposing a cease-and-desist order. This is a close call. Weighing the foregoing, however, I conclude that it is appropriate to issue a cease-and-desist order.

3.2. Monetary penalties

The Securities Act and the Exchange Act each set out a three-tiered system for determining the maximum civil penalty for each act or omission constituting a violation of those acts. 15 U.S.C. §§ 77h-1(g)(2), 78u-2(b). For the time period at issue, the maximum first-, second-, and third-tier penalties under both Acts for each violation, as adjusted by regulation, is $7,500, $75,000, and $150,000, respectively. 15 U.S.C. §§ 77h-1(g)(2), 78u-2(b); 17 C.F.R. § 201.1001, tbl.I. Second- and third-tier penalties are permitted if a respondent's violations involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. 15 U.S.C. §§ 77h-1(g)(2)(B), (C)(i), 78u-2(b)(2), (3)(A). Because Duka's violations did not involve these factors, neither second- nor third-tier penalties may be imposed.

Securities Act Section 8A(g) and Exchange Act Section 21B(a) permit the Commission to impose first-tier civil monetary penalties against any person who violates or causes a violation of those Acts or rules thereunder, if doing so is in the public interest. 15 U.S.C. §§ 77h-1(g)(1), (2)(A), 78u-2(a)(2), (b)(1).

Although the Exchange Act lists six factors to consider when weighing the public interest in relation to monetary penalties, the Securities Act does not. *Compare* 15 U.S.C. § 77h-1(g), *with* 15 U.S.C. § 78u-2(c). The Commission nonetheless relies on the factors listed in the Exchange Act in determining the public interest under the Securities Act. *See Thomas C. Gonnella*, Securities Act Release No. 10119, 2016 WL 4233837, at *14-15 (Aug. 10, 2016).[66] Under the Exchange Act, the factors are:

> (1) whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the resulting harm to other persons; (3) any unjust enrichment and prior restitution; (4) the respondent's prior regulatory record; (5) the need to deter the respondent and other persons; and (6) such other matters as justice may require.[67]

[66] In *Gonnella*, civil monetary penalties were available under Securities Act Section 8A(g), Exchange Act Section 21B(a), Advisers Act Section 203(i), and Investment Company Act Section 9(d). 2016 WL 4233837, at *14. The amount of first- and second-tier penalties the Commission imposed, however, was only available under the Securities Act. *See* 15 U.S.C. §§ 77h-1(g), 78u-2(a), 80b-3(i), 80a-9(d).

[67] These statutory public interest factors considered in relation to monetary penalties are distinguished from the public interest factors, discussed below, considered in relation to determining whether to impose an industry bar. *See Jay T.*

15 U.S.C. § 78u-2(c). Showing the existence of all six factors is not a prerequisite for imposing monetary penalties. *Re. Bassie & Co.*, Accounting and Auditing Enforcement Act Release No. 3354, 2012 WL 90269, at *13 (Jan. 10, 2012).

The Division argues for third-tier penalties, asserting that Duka's conduct involved fraud and deceit and "created a significant risk of substantial losses to investors." Div. Posthearing Br. at 42. I have already rejected the argument that Duka's conduct involved fraud or deceit. It is not entirely clear what evidence exists that Duka's omission, as opposed to S&P's decision to withdraw its ratings, posed a risk to investors. As noted, the decision to withdraw hurt S&P, the marketplace, issuers, and investors. But S&P's republished presales had the same ratings as those in the withdrawn presales and S&P affirmed that the original ratings were consistent with the criteria. This raises the possibility that the withdrawals were a supervening overreaction. I determine that Duka's omission at least contributed to the decision to withdraw the ratings.

Duka was not enriched, unjustly or otherwise, as a result of her omission. She has no disciplinary history. Imposing a penalty would, however, serve the important goals of generally deterring others and specifically deterring Duka from similar omissions in the future.

Although there were eight deficient presales and Duka is liable for two statutory violations, the deficiencies and violations were the result of one, ongoing omission. Balancing the factors above and the fact that this case involves a single, continuing omission, I find it appropriate to impose a single, maximum first-tier penalty of $7,500.

3.3. Bars

Under the Exchange Act, the Commission may censure, suspend, or bar any person from associating with a nationally recognized statistical rating organization if the person has willfully violated any provision of the Securities Act or the Exchange Act or rules under either Act and, at the time of the misconduct, was associated with a nationally recognized statistical rating organization. 15 U.S.C. § 78*o*-7(d)(1)(A) (cross referencing 15 U.S.C. § 78*o*-7(b)(4)(D), authorizing industry bars for willful violations of the securities laws). Under the Investment Company Act, a person who willfully violates any provision of the Securities Act or the Exchange Act or rules under either Act is subject to being prohibited from "serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal

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Comeaux, Exchange Act Release No. 72896, 2014 WL 4160054, at *5 (Aug. 21, 2014).

underwriter." 15 U.S.C. § 80a-9(b)(2). Before imposing a sanction under either provision, the Commission must determine that doing so would be in the public interest. 15 U.S.C. §§ 78*o*-7(d)(1), 80a-9(b).

The Division seeks both types of bar against Duka. Div. Posthearing Br. at 43.

The initial question is whether Duka acted willfully. Willfulness in this context simply means intentionally committing the act that constitutes the violation. *Timothy S. Dembski*, 2017 WL 1103685, at *13. As a result, a respondent can negligently violate the securities laws and still have acted willfully in so doing.[68]

Here, Duka negligently failed to take action. This circumstance raises the question of whether Duka can be said to have intentionally done anything that could constitute a violation. The Commission has held that a negligent omission can constitute a willful act. *See The Robare Grp., Ltd.*, Advisers Act Release No. 4566, 2016 WL 6596009, at *9, *11 (Nov. 7, 2016). In *The Robare Group*, the negligent omission occurred in the context of the respondents' failure to fully disclose information they were required to disclose in Forms ADV. *Id.* at *11. The respondents in *IFG Network Securities* similarly failed to fully disclose information they were required to divulge. *See* 2006 WL 1976001, at *8-9, 12, 14 & n.41.

Although Duka was not responsible for the presales, she did undertake to approve Pollem's proposed language about the use of blended constants. Tr. 1230, 1393-94. She intended this language to describe S&P's process. Tr. 1394. She also undertook her promise to Parisi to ensure disclosure of the use of blended constants. Tr. 1142, 1473-74. Duka's intentional approval of the language in the presale in the context of her broader failure to follow through on her affirmative promise to Parisi amounts to willfulness.

Deciding whether to censure, suspend, or bar a respondent requires consideration of the public-interest factors set forth in *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). *See Edgar R.*

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68 *See David F. Bandimere*, Securities Act Release No. 9972, 2015 WL 6575665, at *26 (Oct. 29, 2015) ("we have applied [*Wonsover v. SEC*, 205 F.3d 408 (D.C. Cir. 2000)] in other contexts, including for violations that had no scienter or negligence requirement"), *set aside on other grounds*, 844 F.3d 1168 (10th Cir. 2016); *C. James Padgett*, Exchange Act Release No. 38423, 1997 WL 126716, at *7 n.34 (Mar. 20, 1997) (rejecting argument that negligent conduct cannot support a finding of willful conduct), *pet. denied sub nom. Sullivan v. SEC*, 159 F.3d 637 (D.C. Cir. 1998) (table decision).

Page, Advisers Act Release No. 4400, 2016 WL 3030845, at *5 & n.14 (May 27, 2016). The public-interest factors include:

> the egregiousness of [Duka's] actions . . . , the isolated or recurrent nature of the infraction, the degree of scienter involved, [her] recognition of the wrongful nature of [her] conduct, the sincerity of [her] assurances against future violations, and the likelihood that [her] occupation will present opportunities for future violations.

Id. at *5. Central to the Commission's consideration of these factors is an evaluation of the risk a respondent "poses to the public" and the degree to which a respondent is judged unfit "to serve the investing public." *Larry C. Grossman*, Securities Act Release No. 10227, 2016 WL 5571616, at *19 (Sept. 30, 2016), *stayed in part*, Securities Act Release No. 10244, 2016 WL 6441565 (Nov. 1, 2016), *remanded*, No. 16-16907 (11th Cir. Aug. 11, 2017). In conjunction with other factors, the Commission also considers the extent to which the sanction will have a deterrent effect. *Toby G. Scammell*, Advisers Act Release No. 3961, 2014 WL 5493265, at *5 (Oct. 29, 2014). The public interest inquiry is "flexible" and "no one factor is dispositive." *Conrad P. Seghers*, Advisers Act Release No. 2656, 2007 WL 2790633, at *4 (Sept. 26, 2007), *pet. denied*, 548 F.3d 129 (D.C. Cir. 2008).

Conduct is egregious if it is "[e]xtremely or remarkably bad" or if it is "flagrant." Black's Law Dictionary (10th ed. 2014). Duka's misconduct does not meet this definition. She did not approach Parisi with the intent to defraud or deceive but instead at the behest of her subordinates because they thought using blended constants was analytically sound. Her failure to ensure that Parisi's direction was followed resulted from negligence not fraudulent intent. And very little evidence of resulting harm actually attributable to Duka's failures was presented.

Duka's omission was ongoing in that it extended to eight presales during a period of several months when she failed to rectify her failure to ensure that the presales disclosed the use of blended constants. Duka recognized that the presales were not sufficiently clear but otherwise did not show that she recognized the wrongfulness of her conduct. She likewise made no assurances against future violations. No evidence was presented about whether Duka's occupation would provide her with a chance to commit additional violations in the future, if she is again employed in a similar capacity.

Aside from her negligent violations in this case, there is no evidence Duka has ever committed any securities violation. Without negating the importance of providing complete and truthful information in CMBS rating presales, the evidence does not support the conclusion that Duka poses a risk to the investing public or is unfit to work in the securities industry.

Bearing in mind that circumstances merely involving negligence are less likely to result in imposition of an industry bar, *see The Robare Group*, 2016 WL 6596009, at *12 n.50, and considering the foregoing factors, I find it appropriate to impose a censure.

4. Record Certification

I certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on May 24, 2017, and corrected on June 16, 2017. *See* 17 C.F.R. § 201.351(b).

5. Order

The Division's claims under Securities Act of 1933 Section 17(a)(1) and (2), Securities Exchange Act of 1934 Section 10(b) and Rule 10b-5 thereunder, and Exchange Act Rules 17g-2(a)(6) and 17g-6(a)(2), are DISMISSED.

Under Section 8A(a) of the Securities Act of 1933 and Section 21C(a) of the Securities Exchange Act of 1934, Barbara Duka shall CEASE AND DESIST from committing or causing any violations or future violations of Section 17(a)(3) of the Securities Act of 1933, and Section 15E(c)(3) of the Securities Exchange Act of 1934.

Under Section 8A(g) of the Securities Act of 1933 and Section 21B(a) of the Securities Exchange Act of 1934, Barbara Duka shall PAY A CIVIL MONEY PENALTY in the amount of $7,500.

Under Section 15E(d) of the Securities Exchange Act of 1934, Barbara Duka is CENSURED for violating Section 17(a)(3) of the Securities Act of 1933.

Payment of civil penalties shall be made no later than 21 days following the day this initial decision becomes final, unless the Commission directs otherwise. Payment shall be made in one of the following ways: (1) transmitted electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) direct payments from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm/htm; or (3) by certified check, bank cashier's check, bank money order, or United States postal money order made payable to the Securities and Exchange Commission and hand-delivered or mailed to the following address alongside a cover letter identifying Respondent and Administrative Proceeding No. 3-16349: Enterprise Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Blvd., Oklahoma City, Oklahoma 73169. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This initial decision shall become effective in accordance with and subject to the provisions of Rule of Practice 360, 17 C.F.R. § 201.360. Under that rule, a party may file a petition for review of this initial decision within 21 days after service of the initial decision. Under Rule of Practice 111, a party may also file a motion to correct a manifest error of fact within ten days of the initial decision. *See* 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then a party shall have 21 days to file a petition for review from the date of the order resolving such motion to correct a manifest error of fact. This initial decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct a manifest error of fact or the Commission determines on its own initiative to review the initial decision as to a party. If any of these events occur, the initial decision shall not become final as to that party.

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James E. Grimes
Administrative Law Judge