Bond Case Briefs

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Ratings Firm Egan-Jones Sanctioned by SEC.

Conflicts of interest are often the predicate for a finding of liability under the securities laws. For example, many of the cases brought against investment advisers are based on the failure to fully disclose a conflict of interest by the adviser. This happens, for example, in the share class selection cases where a broker affiliate of an advisory will receive a fee in connection with the choice of which mutual fund shares to recommend to a client.

Those involved with ratings, such as firms registered with the Commission as Nationally Recognized Statistical Rating Organizations or NRSRO, may also become involved with matters that center on a conflict of interest. In 2008, Congress specifically found that credit rating agencies face conflicts of interest "that need to be carefully monitored, according to Section 932(a) of the Dodd-Frank Act. In view of this fact, the Commission was directed to issue rules to prevent sales and marketing considerations from influencing ratings. To implement this directive the Commission adopted Rule 17g-5(c)(8), for example, to insulate those registered as NRSROs from business pressures by separating the business development function from the analytical function of the firm. It is this mandated separation of functions that is at the center the Commission's most recent case involving a NRSRO, *In the Matter of Egan-Jones Ratings Company*, Adm. Proc. File No,. 3-20902 (June 21, 2022).

Named as Respondents are Egan-Jones Ratings and Sean Egan. The firm is a well-known ratings agency. It registered with the Commission and became an NRSRO for financial institutions, insurance companies, corporate issuers, government and municipal securities and those of foreign governments. Sean Egan, the founder and CEO of the privately held company, is also a Respondent.

In 2013 Egan-Jones was found to have violated Exchange Act Sections 15E(a)(1) and related provisions by making a material misstatement in its form NRSRO and causing violations of Sections 15E and 17(a). The action was resolved with the entry of a cease-and-desist order as to Egan-Jones and the revocation of its registration regarding ratings for asset-backed securities and government securities with a right of reentry after eighteen months. A cease-and-desist order based on Rule 17g-5 was also entered as to Mr. Egan,.

The action here centered on alleged violations of Rule 17g-5(c)(8)(i) regarding the issuance of a rating when there is a conflict of interest and Rule 17(g)-5(c)(1) which is concerned with maintaining a rating for a client that is responsible for 10% or more of the firm's revenue under certain circumstances. First, Egan-Jones issued a rating in 2019 at a time when Respondent Egan had participated in determining the credit rating for the client. The firm founder engaged in sales and marketing activities with respect to the client. This breached the divide between sales and marketing and the issuance of a rating mandated by the Dodd-Frank Act.

Second, Egan-Jones violated the 10% rule. Specifically, in 2017 the firm solicited business from a client that it was aware might contribute over 10% of its revenue for the year. This is contrary to Rule 17g-5(c)(1) of the Exchange Act. While $538,000 was recorded in the year end financial statements in a footnote and labeled as "excess revenue refundable" – the exact amount by which the 10% level was exceeded — the loss contingency was not accrued in accord with GAAP. There

was thus no reason for not tabulating the sum for purposes of the 10% rule.

Respondent firm also failed to establish, maintain and enforce policies and procedures reasonably designed to manage conflicts of interest as required by Rule 15E(h)(1).

Respondent firm agreed to implement certain undertakings, including conducting a training program regarding the matters at issue here and retaining an Independent Consultant. The firm will also develop and implement policies and procedures prohibiting Mr. Egan from participating in the development or approval of any ratings.

The Order alleges violations of Sections 15E(h)(1) and 15E(f)(2) and Rules 17g-(5)(c)(8)(i), 17(g)(5(c)(8)(ii) and 17(g)-5(c)(1). In resolving this action, the firm consented to the entry of a cease-and-desist order based on each of the three Rules citer above and a censure. It will also pay disgorgement of $129,000 along with prejudgment interest of $17,592. In addition, the firm will pay a penalty of $1.7 million.

Respondent Egan also consented to the entry of a cease-and-desist order based on Rules 17g-(5)(c)(8)(i) and 17(g)(5(c)(8)(ii). He will pay a penalty of $300,000.

SEC Actions – Thomas O Gorman

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