

Comment

An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*

An analysis of the current market for ratings of both financial securities and insurance companies reveals significant problems with rating agencies, such as lethargy in changing ratings, political influence, unsolicited ratings, and inaccurate ratings. Examination of various federal regulations indicates that the Securities and Exchange Commission relies heavily on unregulated ratings to exempt issuers of securities from disclosure and registration requirements of federal regulations. To ensure that the federal securities laws continue to protect investors, limited oversight of rating agencies is recommended, including specific proposals. This Comment proposes that Congress enact legislation granting the SEC explicit authority to mandate that all nationally recognized statistical rating organizations (NRSROs) register with the SEC, and to establish minimum standards for the designation of NRSROs. Finally, this Comment examines First Amendment concerns associated with regulation of rating agencies, and concludes that the proposed legislation set forth in this paper would not violate the First Amendment.

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INTRODUCTION

A rating by a nationally recognized statistical rating organization¹ is more important now than ever before. These ratings,² which measure the ability of a corporation issuing debt to repay the purchaser of the debt,³ determine not only the cost of raising capital⁴ but often

1. Currently, there are six nationally recognized statistical rating organizations (NRSROs): Moody's, Standard & Poor's, Fitch, Duff & Phelps, Thomson Bankwatch, and IBCA Banking Analysis Limited. Thomson Bankwatch, Inc., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,800, at 78,595 (Aug. 6, 1991). For a description of the process used to designate a NRSRO, see *infra* note 187 and accompanying text.

2. A rating is intended to indicate the probability that the firm issuing debt will default, or not be able to repay the amount due at the end of the security's life. A rating is a conservative estimate and reflects the rating agency's expectation of the minimum level of quality that the issuing company will be able to maintain. See AHMED BELKAOUI, INDUSTRIAL BONDS AND THE RATING PROCESS 15 (1983). Riskier debt receives lower ratings. To compensate for lower ratings, issuing companies must pay higher interest rates to attract purchasers.

3. Debt financing consists of issuing bonds, in which the issuing company promises to pay the purchaser a specified amount of interest each year and to repay the purchaser an amount stated on the face of the bond, known as the "face amount," at the end of the bond's life. A bond's life ranges from 10 to 20 years. Debt may be preferred to equity for various reasons, such as its effect on the company's debt/equity ratio and the politics of

whether a corporation will survive.⁵ Many corporations are giving disproportionate influence to ratings when making major decisions.⁶ The ratings are also of paramount importance for city and state governments, which increasingly must resort to the debt market to finance government operations.⁷

During the past decade the advent of new and complex variables has both increased the need for rating agencies, because of added market uncertainty, and complicated the job of the rating analyst.⁸ The rise of the junk bond market and greater event risk caused by

corporate control. See ROBERT W. HAMILTON, CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 321-24 (4th ed. West 1990).

4. In February 1991, Standard & Poor's and Moody's downgraded some of Chrysler's debt. Chrysler had guaranteed an issue of \$1.1 billion of debt with interest rates tied to its credit ratings. When its rating was lowered, its interest cost increased by \$38 million per year. *Credit-rating Agencies: Beyond the Second Opinion*, THE ECONOMIST, Mar. 30, 1991, at 80. See also *Agency Lowers GM Credit Rating*, DETROIT FREE PRESS, Feb. 4, 1993, at 1E (downgrade of credit could result in GM having to pay as much as \$300 million more for the money it borrows).

5. One of the most famous recent examples of a company that has gone bankrupt after a downgrade of its rating led to its subsequent inability to raise capital is Drexel Burnham Lambert, Inc. In November 1989, Standard & Poor's lowered the rating on the company's commercial paper from A-2 to A-3. Within weeks, banks and other investors refused to renew about \$400 million in loans to the company. In February of the next year, after unsuccessfully trying to obtain other financing, the company defaulted on \$100 million of commercial paper and filed for bankruptcy. See Robert J. McCartney, *Market Watch; 'Nerds' at Rating Agencies are Wall Street Prophets*, L.A. TIMES, May 14, 1990, at D5. Another example of a company that failed due to inability to raise capital after its rating was lowered by one of the rating agencies is Mortgage Realty Trust. The company, a real estate investment trust, had its rating lowered in March 1990. Within 24 hours, banks began to cut off its credit. Mortgage Realty filed for bankruptcy on April 12, 1990. *Id.*

6. See, e.g., Samuel Fromartz, *Rating Agencies Wield Enormous Clout in Bond Market*, REUTER BUS. REP., Mar. 16, 1992 (General Motors Corporation's plan to fire 74,000 workers and close 21 plants was instigated by a review of the company's debt rating by Moody's and Standard & Poor's); Victor F. Zonana, *Are the Watchdogs Watching?*, L.A. TIMES, July 18, 1991, at A1 (officials of Chemical Banking Corporation and Manufacturers Hanover Corporation stated that one of the main purposes for the merger of the two companies was to improve their credit rating). Standard & Poor's recognizes that many companies incorporate specific rating objectives as corporate goals, yet states that "managing [the corporation] for a very high rating can sometimes be inconsistent with the company's ultimate best interests." S & P'S CORPORATE FINANCE CRITERIA 4 (Frank Rizzo & Solomon Samson eds., 1991).

7. A downgrade in a state's rating can result in an increase of millions of dollars in interest that the state must pay the next time it wants to issue bonds. In April 1990, New York State had its debt downgraded. At the time, it was predicted that the downgrade would cost the state at least \$40 million in interest to issue future bonds. See McCartney, *supra* note 5, at D5.

8. Ida Picker, *The Ratings Game*, INSTITUTIONAL INVESTOR, Aug. 1991, at 73, 77 (major new concerns for credit analysts include event risk and covenant protection).

high-risk business strategies have increased the difficulty of determining ratings.⁹ Today, a rating is not the stable and permanent assessment of a financial security's risk that it used to be. Before 1980, if an issue was rated AA, it was expected to remain AA throughout the life of the security. Now, a rating might be good for as long as five years or as short as six months.¹⁰ Debt downgrades by major rating agencies have become increasingly prevalent during the last decade. During the first half of 1991, ratings were downgraded 422 times compared to 88 upgrades.¹¹ During 1990, downgrades of publicly traded debt outnumbered upgrades by two to one.¹² During the first two quarters of 1992, corporate debt downgrades continued to outnumber upgrades.¹³

Ratings are not only more volatile and increasingly difficult to assign, but are also assuming an unprecedented significance in both the insurance industry¹⁴ and the securities marketplace.¹⁵ Both consumers and institutional investors rely heavily on ratings in deciding whether to purchase a security. An estimated seventy-nine percent of individual investors claim that a rating is the most important factor in their investment decision.¹⁶ In addition, major governmental agencies such as the Securities and Exchange Commission (SEC) increasingly rely on ratings in promulgating major securities regulations.¹⁷ For example, the SEC recently prohibited the investment of money-market funds in commercial paper with a low rating.¹⁸ The SEC also allows public companies to use Form S-3 to register debt that has an investment-grade rating.¹⁹ The SEC also allows registered brokers and dealers to use ratings to value bond

9. David Zigas, *Why the Rating Agencies Get Low Marks on the Street*, BUS. WEEK, Mar. 12, 1990, at 106.

10. See Adrienne Linsenmeyer, *Rating Game: Credit Rating Agencies Are Scrambling to Upgrade Themselves*, FIN. WORLD, Aug. 21, 1990, at 56, 57.

11. Picker, *supra* note 8, at 77.

12. Linsenmeyer, *supra* note 10, at 56.

13. *Credit Ratings: Downgrades by S&P on Corporate Debt Slowed in 2nd Period*, WALL ST. J., June 30, 1992, at C11.

14. See, e.g., Joseph L. Petrelli, *On the Power of the Rating Agencies*, NAT'L UNDERWRITER, PROP. & CASUALTY/RISK & BENEFIT MGMT. EDITION, Sept. 30, 1991, at 35; David C. Jones, *Pomeroy Says NAIC Should Rate Rating Agencies*, NAT'L UNDERWRITER, PROP. & CASUALTY/RISK & BENEFIT MGMT. EDITION, Aug. 12, 1991, at 1.

15. See, e.g., Abby Schultz, *Wake-up Call for the Rating Agencies*, INVESTMENT DEALERS' DIG., Oct. 28, 1991, at 18. See also *infra* note 154 and accompanying text.

16. Stephen Fidler, *Most Investors Still Rely Heavily on Rating Agencies*, FIN. TIMES, Dec. 4, 1990, at 33.

17. See Roger Fillion, *SEC Officials Clash Over Regulation of Rating Agencies*, REUTER BUS. REP., Aug. 13, 1992 ("What's more, even regulators have become increasingly dependent on the data the rating agencies provide when setting rules for the stock and bond markets.").

18. See *Credit-rating Agencies: Beyond the Second Opinion*, *supra* note 4.

19. See *infra* note 161 and accompanying text.

assets for purposes of determining net capital requirements.²⁰

Ratings are also increasingly important in the insurance industry, which has assets of \$1.6 trillion.²¹ Insurance companies hold huge blocks of bonds as assets, and the ability of the insurance company to pay policyholder claims depends upon the safety of these assets. When First Executive Life was seized by state regulators on April 11, 1991, it was the largest insurance company failure in United States history.²² First Executive Life had a very high percentage of its assets in junk bonds²³ and many blamed the rating agencies for not downgrading the company's rating soon enough.

Representative John Dingell, Chairman of the House Energy and Commerce Committee, is currently considering drafting legislation proposing regulation of bond rating agencies.²⁴ Securities and Exchange Commissioners Richard Roberts and Mary Schapiro have also indicated support for regulation of rating agencies.²⁵ However, SEC chairman Richard Breeden has stated that he opposes regulation of the rating agencies.²⁶ In the insurance industry, the head of

20. The rating must be issued from a nationally recognized statistical rating organization, as defined in the 1934 Act, Rule 15c3-1(c)(2)(vi)(F), 17 C.F.R. § 240.15c3-1(c)(2)(vi)(F) (1992). A security is considered to be investment-grade if one of the four highest ratings is assigned to it by a NRSRO. 12 U.S.C. § 1831e(d)(4)(A) (1992). Assets rated investment-grade by a NRSRO receive haircut deductions ranging from 2% to 9%. *Id.* Absent such a rating, assets are subject to much higher haircut deductions. 17 C.F.R. § 240.15c3-1(c)(2)(vi)(J). For Standard & Poor's, the security would have to receive a rating of AAA, AA, A, or BBB. For Moody's, the security would have to receive a rating of Aaa, Aa, A, or Baa. See BELKAOUI, *supra* note 2, at 11-14.

21. *Industry's Assets Rose 12.2% to \$1.6 trillion at Year-end '91*, NAT'L UNDERWRITER: LIFE & HEALTH/FIN. SERVICES EDITION, June 8, 1992, at 10. Cf. Gerald W. Perritt, *Where the Money Is*, FORBES, July 6, 1992, at 125 (insurance company assets equal \$1.52 trillion).

22. See *infra* note 61 and accompanying text.

23. Junk bonds are bonds rated below investment-grade. See HAMILTON, *supra* note 3, at 321. First Executive Life had around 65% of its assets invested in junk bonds. This was more than 216% of the industry average. See *infra* note 67 and accompanying text.

24. See Aaron Pressman, *Dingell May Draft New Law Regulating Rating Agencies*, INVESTMENT DEALERS' DIG., May 11, 1992, at 5.

25. *Roberts, Schapiro Seek Legislation Giving SEC Power Over Rating Agencies*, 24 SEC. REG. & L. REP. 1269, 1269 (1992); see also Roger Fillion, *SEC Officials Clash Over Regulation of Rating Agencies*, REUTER BUS. REP., Aug. 13, 1992 (noting that Commissioners Roberts and Schapiro have called for a definition of what constitutes a rating agency and for SEC power to oversee the agencies); Aaron Pressman, *Two SEC Commissioners Favor Regulating Ratings Agencies*, INVESTMENT DEALERS' DIG., Aug. 17, 1992, at 10 (Commissioners Roberts and Schapiro favor a legislative definition of NRSRO and explicit authority for SEC to regulate the agencies).

26. See Aaron Pressman, *Dingell Demands Response from SEC Chairman Breeden*, INVESTMENT DEALERS' DIG., July 20, 1992, at 11. See also Pressman, *supra* note 25.

the National Association of Insurance Commissioners (NAIC) has called for regulation of the rating agencies.²⁷

This Comment examines the current status of rating agencies in both the financial securities and insurance industries. Part I is an examination of allegations of problems with ratings and rating agencies. Although many insist that market competition ensures a proper standard of care among rating agencies,²⁸ the existence of serious problems in the industry refutes this proposition. Part I includes examination of allegations of the slowness of rating agencies in downgrading ratings (subpart A), political influence (subpart B), unsolicited ratings (subpart C), and inaccuracy and lack of disclosure (subpart D). Part II is an analysis of the Securities and Exchange Commission's reliance on ratings to justify exempting issuers of financial securities from disclosure requirements. Part III includes recommendations for limited regulation of rating agencies by the SEC and the NAIC. Part IV examines First Amendment concerns with the legislation proposed in Part III.

I. REBUTTAL OF THE ASSERTION THAT THE MARKET EFFICIENTLY DISCIPLINES RATING AGENCIES: LETHARGY, POLITICS, UNSOLICITED RATINGS, AND INACCURACY AND LACK OF DISCLOSURE

A. *Lethargy In Downgrading A Rating*

(i) *The Financial Securities Market*²⁹

The strongest argument that the market is not effectively ensuring a proper standard of care among the rating agencies is the existence

27. David C. Jones, *Pomeroy Says NAIC Should Evaluate Rating Agencies*, NAT'L UNDERWRITER, LIFE & HEALTH/FIN. SERVICES EDITION, Aug. 19, 1991, at 6.

28. See, e.g., Vicky Stamas, *Only a Minority Backs Creating More Rules as Market Debates Rating Agency Role*, BOND BUYER, Aug. 31, 1992, at 1 (majority of securities market participants responding to SEC's request for comments on proposal to exempt highly-rated structured financings from registration requirements opposed further regulation of rating agencies); Christopher Dauer, *Criticisms Lead to Minor Changes by Rating Agencies*, NAT'L UNDERWRITER, PROP. & CASUALTY/RISK & BENEFIT MGMT. EDITION, June 22, 1992, at S3, S25 (S&P's Ron Taub claims rating agencies are effectively monitored by the marketplace); Fillion, *supra* note 25 (SEC Chairman Richard Breeden claims agencies are already subject to strong discipline from financial markets); Gregory Husisian, Comment, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 425-26 (1990) (market is a sufficient check on rating agencies).

29. Six players compose the financial securities ratings market: Standard & Poor's, Moody's Investor's Service, Inc., Fitch, Duff & Phelps, Thomson Bankwatch, and IBCA Banking Analysis Limited. Standard & Poor's, Moody's, and Fitch have all been issuing ratings since the early 20th century. Louis H. Ederington & Jess B. Yawitz, *The Bond Rating Process*, in HANDBOOK OF FINANCIAL MARKETS AND INSTITUTIONS (Edward I. Altman et al. eds., 6th ed. 1987). "Moody's started rating railroad bonds in 1909 and started issuing ratings for utility and industrial debt in 1914. Poor's began issuing ratings

of serious problems afflicting the ratings market. Perhaps the most frequent and long-standing complaint against rating agencies is that they are too slow to downgrade a rating.³⁰

In 1975,³¹ both Standard & Poor's and Moody's were heavily criticized for waiting too long to change New York City's bond rating.³² Standard & Poor's changed its rating in April 1975, and Moody's changed its rating the following October. However, critics complained that obvious warning signs that existed the previous fall should have caused the rating agencies to downgrade the state's debt rating sooner.³³ Critics not only charged the two agencies with being slow to downgrade, but also with a complete failure to investigate the city's fiscal problems.³⁴

In 1983, the two rating agencies were criticized for being too slow to downgrade bonds issued by the Washington Public Power Supply System (WPPSS).³⁵ WPPSS had issued \$8.3 billion of bonds to finance the construction of five nuclear power plants. WPPSS eventually defaulted on \$2.25 billion of the bonds, representing that portion of the bonds issued to finance construction of the fourth and fifth

in 1922 and Standard Statistics in 1923. The two merged into Standard & Poor's in 1941. Fitch ratings appeared in 1923." *Id.* at 23-4 to 23-5. The first three rating agencies disseminate public ratings and use similar rating symbols. *Id.* Duff & Phelps began rating utility bonds in the 1930s, but did not issue public ratings until 1980. Private ratings are ratings only available to the customer, and are not disseminated to the general public.

This Comment will focus on Moody's Investors Service, Inc., and Standard & Poor's. These two organizations dominate the financial securities market for ratings, which is a differentiated oligopoly. In a differentiated oligopoly, several players produce similar yet differentiated products. A. ASIMAKOPOULOS, AN INTRODUCTION TO ECONOMIC THEORY: MICROECONOMICS 219, 311 (1978).

30. See, e.g., Jonathan Fuerbringer, *Chrysler Notes Are Well Received*, N.Y. TIMES, Dec. 10, 1992, at D14 ("The sale of the notes prompted the usual remarks in the bond market about credit rating agencies and what many in the market say is their lateness in lowering or raising a company's rating.").

31. Criticism regarding failure of Moody's and Standard & Poor's to change a rating quickly enough predates 1975. Though this Comment focuses on problems currently posed by the rating agencies, a sampling of significant past problems is presented to demonstrate the continuity of the problems. For an example of pre-1975 complaints, see Marilyn Much, *The Rating Game: When Baa Spells Bah*, INDUSTRY WEEK, Jan. 8, 1979, at 45-46 (both agencies criticized in early 1970s for sluggishness in changing ratings); JOHN E. PETERSEN, THE RATING GAME: REPORT OF THE TWENTIETH CENTURY FUND TASK FORCE ON MUNICIPAL BOND CREDIT RATINGS (1974) [hereinafter RATING GAME] (analysis of problems with ratings in the municipal bond industry).

32. See Bradley Graham, *Mystery Pervades Rating Agencies' Bond Market Role*, WASH. POST, Oct. 8, 1978, at F1. See also Zonana, *supra* note 6, at A1.

33. Graham, *supra* note 32, at F1.

34. *Id.*

35. Peter Brimelow, *Shock Waves from WHOOPS Roll East*, FORTUNE, July 25, 1983, at 46. See also Zonana, *supra* note 6, at A14.

nuclear plants. It was the largest bond default in securities history.³⁶ In May 1981, construction cost increases resulted in a suspension of construction of plants four and five. When efforts to raise additional financing proved unsuccessful, WPPSS abandoned construction on the two plants.³⁷

WPPSS intended to repay the \$2.25 billion of bonds by relying on participation agreements entered into with eighty-eight publicly owned regional utilities. These participation agreements obligated the utilities to pay for the costs of the projects regardless of whether the projects were ever completed.³⁸ In June 1983, however, the Washington Supreme Court ruled that certain of the regional utilities, whose combined participation agreements represented sixty-eight percent of the cost of the projects, lacked authority to enter into the agreements.³⁹ On remand to the Washington Superior Court, the remaining participants' agreements were held to be unenforceable. On appeal, the Washington Supreme Court affirmed, thus releasing the remaining participants from liability.⁴⁰ After this ruling, WPPSS had no means of repaying the bonds, and was forced to default. The default resulted in many lawsuits being filed against WPPSS and other defendants, including Standard & Poor's and Moody's.⁴¹ The suits alleged material misrepresentations or omissions in the bond prospectuses.⁴² Additionally, the Securities and Exchange Commission investigated the default.⁴³

36. *SEC Closes WPPSS Investigation, Without Bringing Enforcement Action*, 20 SEC. REG. & L. REP. 1435 (1988).

37. *Id.*

38. *Id.*

39. *Chemical Bank v. Washington Pub. Power Supply Sys.*, 666 P.2d 329 (Wash. 1983), *aff'd on reh'g*, 691 P.2d 524 (Wash. 1984), *cert. denied* 471 U.S. 1065 (1985).

40. 691 P.2d 524 (Wash. 1984), *cert. denied* 471 U.S. 1065 (1985).

41. The litigation included a class action which was settled in 1988 by payment of more than \$580 million, before interest. *Class Plaintiffs v. City of Seattle*, 720 F. Supp. 1379 (D. Az. 1989), *aff'd* 955 F.2d 1268 (9th Cir. 1992). Four previously approved settlement agreements involved payments of an additional \$107 million. *Id.* at 1275. *See Judge Signs Order Settling Class Suit Brought Against WPPSS for Bond Default*, 20 SEC. REG. & L. REP. 1720 (1988).

42. 955 F.2d 1268, 1274-75.

43. The SEC chose not to pursue enforcement action against WPPSS because of the plethora of private litigation against WPPSS and prohibitive discovery costs. *See SEC Closes WPPSS Investigation Without Bringing Enforcement Action*, *supra* note 36, at 1435. However, the SEC noted that serious problems existed with investors obtaining information regarding municipal bonds, especially when the bonds are purchased in secondary markets. In order to attempt to remedy this deficiency, and to reduce the likelihood of future defaults of municipal bonds, the SEC approved Rule 15c2-12 under the Securities Exchange Act of 1934. *See New SEC Rule Will Require Underwriters in Bond Offerings to Distribute Data*, 21 SEC. REG. & L. REP. 936, 937 (1990). The rule became effective January 1, 1990, and requires underwriters participating in municipal bond offerings exceeding \$1 million to obtain and review copies of almost all official statements by the bond issuer before bidding for or purchasing an offer. The rule also requires underwriters to make available copies of such final statements to investors who request them. *Id.* The rule was based largely on the SEC's investigation of the WPPSS

Critics charged that Moody's and Standard & Poor's failed to downgrade the bonds despite awareness of serious difficulties and cost overruns involved with construction of the plants.⁴⁴ A bond research company, L.F. Rothschild Unterberg Towbin, had suspended its ratings on the bonds in June 1981, six months before Moody's took similar action.⁴⁵ Presumably, the rating agencies did not lower the rating because the WPPSS was a quasi-government agency and, thus, was very secure because of its ability to ensure debt payments through the sale of electricity. The rating agencies cannot be faulted for failing to predict the decision by the Washington Supreme Court. However, the rating agencies could have dropped their rating at least one notch. This would have alerted investors that some change had occurred, and allowed them to conduct their own investigation. Maintaining a high rating despite huge cost overruns gave the false impression that all was well.⁴⁶

Critics also wondered whether the agencies had too collegial a relationship with the WPPSS. Both agencies received a combined total of over \$400,000 in the ten years preceding 1983 from the WPPSS.⁴⁷ At Moody's, an employee who wanted to downgrade the bonds earlier was overruled, and later quit.⁴⁸

default, which noted that none of the rating agencies took responsibility for conducting adequate investigation of the bond offerings. *Id.*

44. See Brimelow, *supra* note 35, at 46. For a detailed account of the WPPSS saga, see Peter W. Bernstein, *A Nuclear Fiasco Shakes the Bond Market*, FORTUNE, Feb. 22, 1982, at 100.

45. See Brimelow, *supra* note 35, at 47.

46. The rating agencies were not the only ones to prevent crucial information from being disseminated to the public. The Securities and Exchange Commission's investigation into the matter revealed that WPPSS failed to disclose important events. For example, it failed to disclose that it had been asked by the participating utilities in October 1980 to consider possible termination of the project. It also failed to disclose in November 1980 a \$4.5 billion estimated budget increase. *SEC Closes WPPSS Investigation Without Bringing Action*, *supra* note 36, at 1436. Thus, the rating agencies were not the only ones to blame for the lack of disclosure of important information concerning the bonds to the public. However, the type of information that WPPSS failed to disclose was precisely the type of information that the rating agencies had special access to because of their relationship with WPPSS. Thus, the rating agencies are equally as culpable as WPPSS for failing to timely disclose such information.

47. Brimelow, *supra* note 35, at 47. Suggestions of conflict of interest have also been raised with respect to ratings of insurance companies. See Eric N. Berg, *Insurers' Raters Are on the Spot For Inaccuracy*, N. Y. TIMES, Aug. 4, 1991, at A1, A36 ("Another complaint is what critics call a conflict of interest. Insurers pay Moody's and Standard & Poor's up to \$30,000 a year for ratings. A. M. Best rates insurers for a nominal sum, but is constantly selling industry guides, reports and newsletters to insurers and agents. Because the ratings agencies depend on the industry for revenues, the agencies might be reluctant to cut ratings, critics contend.").

48. Brimelow, *supra* note 35, at 46-47.

Another example of a situation in which critics alleged lethargy by the rating agencies in downgrading a bond's rating is Integrated Resources. On Thursday, June 15, 1989, the company announced that it would default on \$1.5 billion of bonds and commercial paper.⁴⁹ Standard & Poor's had rated the commercial paper A2 (borderline investment-grade) until the day before.⁵⁰ The next day Standard & Poor's downgraded its rating to CCC-, a low junk bond rating.⁵¹ Integrated Resources' stock, that had traded at \$17.38 on May 15, 1989, and at \$15.38 on June 13, 1989, dropped to \$6.25 on June 15, 1989.⁵² Many people criticized the rating agencies for waiting too long to downgrade the rating. Although both Standard & Poor's and Moody's had put the company on CreditWatch,⁵³ neither actually downgraded the rating until the day the default was announced.⁵⁴ The failure of the rating agencies to downgrade Integrated Resources' debt earlier left even some sophisticated investors who had relied on the rating without a remedy.⁵⁵

49. See Kurt Eichenwald, *Integrated Resources to Default*, N. Y. TIMES, June 16, 1989, at D1.

50. Zigas, *supra* note 9, at 108.

51. Eichenwald, *supra* note 49, at D1.

52. Mary Kuntz, *Debt Wobbles Integrated Resources*, NEWSDAY, June 26, 1989, at 3.

53. CreditWatch, pioneered in 1981, refers to an announcement by a rating agency that it is re-evaluating the condition of the issuer. CreditWatch is supposed to alert the public that a rating change may be imminent. Linsenmeyer, *supra* note 10, at 56. However, people in the industry claim that CreditWatch is not effective because most companies are downgraded without being placed on CreditWatch. In addition, a CreditWatch announcement leads to an instant adjustment of the market price of the company's debt to reflect the potential for a downgrade. *Id.* The ratings of most of the companies placed on CreditWatch, however, are not changed. According to Ken Pinkes, Moody's vice-president in charge of financial institutions, Moody's only ends up changing about half of the companies that it places on CreditWatch. *Id.* Standard & Poor's CreditWatch announcements are announced in a weekly publication called CREDITWEEK. See, e.g., S & P's CREDITWEEK, Sept. 21, 1992 (Matthew J. Korten ed.). A subscription to Creditweek cost \$1,865 per year in 1992.

54. Stephanie Cooke, *Integrated Resources: Where Were the Rating Agencies?*, INSTITUTIONAL INVESTOR, Aug. 1989, at 28.

55. For an example of sophisticated investors who detrimentally relied on the rating of Integrated Resources in purchasing loan participations from a bank, see *Banco Español de Crédito v. Security Pac. Nat'l Bank*, 973 F.2d 51 (2d Cir. N.Y. 1992). In that case, two groups of institutional investors had purchased loan participations from Security Pacific National Bank of a short-term loan which the bank had made to Integrated Resources. A loan participation is a sale of a loan from one institution to another. It provides benefits to both parties: the seller, or primary lender, benefits by spreading the risk that the borrower will default; the purchaser of the loan participation benefits by receiving interest greater than that available on comparable money market instruments. *Id.* at 53.

Security Pacific did not disclose to the purchasers of the loan participation that it had refused, in April 1989, to extend further credit to Integrated Resources. Instead, Security Pacific only provided the purchasers with Integrated Resources' publicly available debt rating. *Id.* at 56-57 (Oakes, Chief J., dissenting). Even though the investors had signed a disclaimer stating that they had independently investigated the creditworthiness

(ii) The Insurance Industry

In the insurance industry, the rating agencies have also been criticized for being too slow to downgrade the ratings of insurance companies. In 1984, critics charged that A.M. Best Company⁵⁶ was slow to downgrade Ideal Mutual Insurance Company of New York.⁵⁷ Best had downgraded the company to C from A only four months before it entered rehabilitation in December 1984.⁵⁸ Similar allegations were levied against Standard & Poor's and A.M. Best after the collapse of First Capital in 1991. By spring of 1991, it was common knowledge in the insurance industry that First Capital had large holdings of speculative junk bonds. Pension fund managers had begun to discontinue investment in First Capital.⁵⁹ Still, Standard & Poor's maintained an investment-grade rating, BBB, of First Capital until May 7, 1991, one week before the insurer was taken over by the California Insurance Commissioner. First Capital retained a rating of A-, or excellent, by Best until the day of the takeover.⁶⁰

Rating agencies were also heavily criticized when First Executive Life was seized by California state regulators on April 11, 1991.⁶¹ It was the largest insurance company failure in United States history.⁶²

of Integrated Resources, and were not relying on representations made by Security Pacific, the investors relied solely on the rating. *Id.* at 53. When Integrated defaulted on its loan in June 1989, the purchasers of the loan participations were left without a remedy. They could not recover under § 12 of the Securities Act of 1933 because the court determined that the loan participation was not a security. They could not recover under a common-law fraud cause of action because they had signed the disclaimer. *Id.* at 54. Thus, sophisticated investors who relied on Integrated Resources rating were left without recourse when Integrated defaulted. *See also 'Loan Notes' Sold by Bank are Securities, SEC Tells CA 2 in Brief*, 24 Sec. Reg. & L. Rep. 172, 172-73 (1992) (detailing case and noting that borrower only provided purchasers with ratings by credit rating agencies).

56. A.M. Best Co. is an insurance-company rating agency. It does not rate financial securities as do Moody's and Standard & Poor's. For a description of A.M. Best, see NAIC REPORT, *infra* note 126, at 105-06.

57. *See, e.g., Michael Schachner & Douglas McLeod, Rating Agencies: Do They Do the Job? Burned Policyholders Sue Following Failures*, BUS. INS., Aug. 5, 1991, at 1, 31.

58. *Id.*

59. *See Berg, supra* note 47, at A1.

60. *Id.* Best's spokesman, Paul Wish, commented that the reason that Best maintained its rating until the day First Capital was taken over was that Best had not factored into its rating analysis whether an insurer could survive a run (a massive withdrawal of funds by investors). *Id.* In August 1991, Best announced that it would begin to include such a possibility when performing its rating analysis. *Id.*

61. *See Sabin Russell, State Takes Over Insurer That Was Big in Junk Bonds*, S.F. CHRON., Apr. 12, 1991, at A1.

62. *See Jay Greene, Judging the Soundness of Insurers*, DAILY NEWS OF L.A., Apr. 14, 1991, at B1.

In 1991, First Executive Life had 170,000 policies nationwide with a face value of \$38 billion, 75,000 annuity contracts worth \$2.5 billion, and 300 guaranteed investment contracts worth more than \$3 billion.⁶³ Prior to January 1990, Best had rated First Executive Life A, Standard & Poor's had rated it AAA, and Moody's had rated it A3.⁶⁴ Beginning in January, all three agencies began a rapid series of downgrades, eventually rating the bonds lower than investment-grade. Critics of the rating agencies claimed that waiting until January to downgrade the debt was reprehensible because the ability of First Executive Life to pay interest obligations on its outstanding bonds had been substantially undermined for several years due to the company's high percentage of junk bonds in its investment portfolio.

An analysis of the events leading up to January 1990 reveals that both public and private information⁶⁵ provided ostensible warning signs that should have caused the rating agencies to downgrade First Executive Life's rating.⁶⁶ When First Executive Life of California failed, more than sixty-five percent of its assets were in junk bonds.⁶⁷ The insurance industry as a whole in 1990 only had three percent of its \$1.3 trillion in assets invested in junk bonds.⁶⁸

First Executive Life's problems began in 1974 when its chairman, Fred Carr, joined the company. In 1978 Carr pioneered the company's introduction of single-premium deferred annuities.⁶⁹ These annuities, which promised investors a large return in the future for a relatively small present investment, became very popular and resulted in remarkable growth for Executive Life.⁷⁰ As the company realized tremendous gains in profitability and net worth, it received

63. Russell, *supra* note 61.

64. Kathy M. Kristoff, *Lax Regulators Are Blamed for Insurer's Fall*, L.A. TIMES, Sept. 1, 1991, at D1.

65. Public information refers to any information available to the general public, such as newspapers, journals, and the media. Private information is that information not available to the general public, yet available to the rating agencies because of their relationship to the issuer. The issuer discloses confidential corporate information to the rating agencies during and after the rating process. See, e.g., S & P's CORPORATE FINANCE CRITERIA, *supra* note 6, at 9. "A substantial portion of the information set forth in company presentations is highly sensitive and is provided by the issuer to S&P only for the purpose of arriving at ratings It is not used for any other purpose, or by any third party" This information is also available to the rating agency subsequent to the issuance of the rating, during the "surveillance and review" portion of the rating agency's job. *Id.* at 10. S&P meets at least once a year with the issuer of the debt, at which time the issuer presents S&P with confidential corporate information and reveals its plans for the future. *Id.*

66. See Zonana, *supra* note 6, at A1 ("Consistently, the ratings agencies continued to give top rating to [Executive Life and First Capital Life] at a time when anybody with a room temperature IQ in the industry knew they were in trouble.") (quoting Richard H. Bryan (D-Nev)).

67. Kristof, *supra* note 64, at D16; Russell, *supra* note 61, at A1.

68. John Waggoner, *Life Insurance: Safe Bet?*, USA TODAY, Dec. 17, 1990, at B1.

69. Kristof, *supra* note 64, at D16.

70. *Id.*

high ratings from the rating agencies.⁷¹ Carr was taking home million-dollar paychecks and receiving rave reviews in newspapers and magazines.⁷² Carr financed the annuities with a portfolio of assets that contained over 216% more junk bonds than the industry average.⁷³ Despite the fact that these junk bonds were financial instruments of unproven reliability, and the fact that First Executive Life had such an incredibly high ratio of junk bonds in its portfolio, the rating agencies maintained an investment-grade rating for the company until a year before it was seized by state regulators in California.

Several times before 1986 state regulators had contended that First Executive Life's net worth had been overstated by tens of million of dollars.⁷⁴ In 1986, California state regulators forced the company to reduce its reported net worth by \$180 million.⁷⁵ Even though this information was not generally disseminated to the public,⁷⁶ the rating agencies either had such information or could have obtained it through minimal investigation. Because the agencies were privy to the company's financial information, a routine examination of the company's financial statements would have revealed the significant decrease in reported net worth.⁷⁷

71. *Id.*

72. *Id.* However, no one took notice of the fact that the mutual fund that Carr had managed at his previous job collapsed shortly after his departure. *Id.*

73. Waggoner, *supra* note 68; Kristof, *supra* note 64. See also Jay Greene, *Insurance Regulators Seize Executive Life*, DAILY NEWS OF L.A., Apr. 12, 1991, at N1 (\$6.4 billion of First Executive Life's \$10.1 billion in assets invested in junk bonds).

74. Kristof, *supra* note 64, at D16.

75. *Id.* First Executive Life had exaggerated its net worth by claiming huge improper reinsurance credits. Reinsurance is a procedure by which one insurance company sells a portion of its policies to another insurance company in order to spread risk. Regulators in both New York and California found these credits to be phony. *Id.* New York regulators fined First Executive Life of New York \$250,000, required it to raise its capital, and barred three executives from signing financial statements issued by the company. *Id.*

76. See Kristof, *supra* note 64, at D16 (noting that investors were not generally aware of First Executive Life's problems with state regulators).

Publicly held insurance companies file two annual reports. One, based on generally accepted accounting principles (GAAP), is sent to shareholders. First Executive Life's GAAP financial statement did not disclose much about the regulatory problems. *Id.* The second required report is based on regulatory accounting principles (RAP) and is sent to state regulators. *Id.* Thus, neither of these two reports effectively informed the public about the regulators' reprimand of the company. Additionally, the regulators' actions did not increase public awareness. Although the California examiners required First Executive Life to correct financial statements filed in California, they did not require the company to change statements filed in other states in which the company did business. *Id.* at D1.

77. The decrease left First Executive Life with only \$90 million in net worth. *Id.*

Pressured by state regulators in California to increase capital, First Executive Life obtained a \$170 million loan from Executive Life of New York in December 1987.⁷⁸ Though the company reported this as an asset in its financial statement of December 31, 1987, it did not receive the money until the following year. The rating agencies downplayed this intentional falsification as a technical violation, and assessed its impact as minimal on the company's financial health.⁷⁹ Critics have complained that the rating agencies should have investigated the situation more carefully and downgraded the debt to reflect the company's significantly impaired ability to meet the interest obligations on its debt.

Events between 1988 and 1991 revealed the company's financial distress. Information regarding these events was largely public and makes reprehensible the rating agencies' failure to downgrade First Executive Life's rating more quickly. In December 1988, the company, desperate to increase capital, exchanged \$700 million in junk bonds for collateralized bond obligations.⁸⁰ These new securities, however, were backed by similar junk bonds. When state regulators finally found out about the transaction a year later, they voided the transaction.⁸¹

In March 1989, Michael Milken, the head of Drexel Burnham Lambert, was indicted on charges of insider trading.⁸² First Executive Life's parent, First Executive Corporation, had been the largest single buyer of the junk bonds sold by Milken.⁸³ First Executive Life posted the biggest annual loss in its history in 1989 due to losses from its junk bond portfolio.⁸⁴ Despite all this, the rating agencies did not lower their ratings of First Executive Life.⁸⁵

In March 1990, the Securities and Exchange Commission began an investigation of First Executive Life's financial reporting practices.⁸⁶ Between December and March, policyholders had pulled

at D16.

78. *Id.*

79. *Id.*

80. *Id.* The company took a huge credit on its balance sheet for reducing the riskiness of its portfolio.

81. *Id.*

82. *Id.*

83. Russell, *supra* note 61, at A1.

84. Kristof, *supra* note 64, at D16.

85. The rating agencies were not the only ones that delayed taking action. State regulators in New York and California also failed to act despite knowledge of the insurer's problems. See Fred Perlmutter & Frank Russo, *Regulating at a Snail's Pace; State Regulation of Financially Troubled Insurers Is Inadequate, Uneven*, BEST'S REVIEW, PROP./CASUALTY INS. EDITION, Dec. 1992, at 22 ("Despite their knowledge of Executive Life's questionable investments, improper reinsurance, improper affiliate transactions and loss reserve deficiencies, regulators did not act promptly to correct the problems or to minimize their effects.").

86. *Id.*

more than \$3 billion out of the company. After the company posted another devastating loss in March 1990, more policyholders hurried to withdraw their assets. Standard & Poor's, though it had lowered its rating to BBB, still maintained that the company was secure. However, even magazine writers were counseling policyholders to abandon their investments in First Executive Life.⁸⁷ In April, regulators in New York and California finally seized the company and placed temporary bans on policyholder withdrawals.⁸⁸

Just days after regulators seized First Executive Life on April 11, 1991, lawsuits began to be filed against the company's directors and executives, and against the rating agencies. By August, Standard & Poor's, Best, and Moody's had been named in more than twenty lawsuits filed by policyholders.⁸⁹ Significantly, Duff & Phelps was never named in any of these lawsuits. Duff & Phelps never rated First Executive Life higher than BBB after 1988. It gave realistic weight to the obvious risk of default from the company's huge junk bond holdings.⁹⁰ This emphasizes the negligence of the other rating agencies in failing to downgrade their ratings sooner. All the rating agencies had access to the same information and should have downgraded much earlier than they did.

One suit, filed in April 1991 in Superior Court of San Francisco, was brought on behalf of a twelve-year-old girl whose annuity was managed by First Executive Life.⁹¹ The complaint alleged that First Executive Life's chairman, Fred Carr, worked together with Michael Milken to maintain the price of junk bonds artificially high by buying huge amounts of junk bonds from Milken and other firms.⁹² The suit claimed that the girl's annuity was in jeopardy because of First Executive Life's high-risk portfolio. The suit also named as defendants Moody's and Standard & Poor's. It claimed that the two rating agencies negligently maintained high ratings for First Executive Life until 1990, thus deceiving investors by suggesting that the company was financially stable.⁹³

Most of the other lawsuits filed against the agencies make similar

87. See Jane Bryant Quinn, *Checking Out the Junk Shop*, NEWSWEEK, Apr. 9, 1991, at 46 ("Ask your employer who backs up your guaranteed-investment contract. If Executive Life is in the mix, it costs you nothing to switch to another investment.").

88. *Id.*

89. Schachner & McLeod, *supra* note 57, at 1.

90. *Id.* at 31.

91. Dan Morain, *Executive Life Fraud Alleged in Lawsuit*, L. A. TIMES, Apr. 18, 1991, at D6.

92. *Id.*

93. *Id.*

allegations.⁹⁴ They all charge the agencies with negligence and misrepresentation in failing to warn of the riskiness of First Executive Life's extensive junk bond holdings. Some have even characterized the rating agencies' failure to downgrade earlier as recklessness.⁹⁵

On February 21, 1992, California Commissioner of Insurance John Garamendi filed suit in Los Angeles Superior Court against First Executive Life's Fred Carr, Michael Milken, A.M. Best, Moody's, and Standard & Poor's.⁹⁶ Garamendi, suing on behalf of policyholders of First Executive Life, charged the rating agencies with fraud, deceit, negligence, and negligent misrepresentation. Garamendi's complaint stated that the rating agencies negligently misrepresented First Executive Life's financial strength by maintaining a high rating for the company, despite First Executive Life holding a portfolio of junk bonds far in excess of any other insurance company.⁹⁷ Garamendi also noted that the rating agencies' failure to downgrade was negligent because they had access to confidential corporate information that belied the ratings' suggestion that the company was financially sound.⁹⁸ Milken has already settled for \$100 million.⁹⁹

In all these cases, no one charges the agencies with negligence in assessing the initial rating. However, as the First Executive Life fiasco illustrates, failure of the rating agencies to downgrade a rating quickly enough is a serious problem. The rating agencies frequently downplay their ratings as mere opinions.¹⁰⁰ The extreme importance

94. One suit filed in New York State Supreme Court accuses the rating agencies of misrepresenting First Executive Life's financial condition. *Id.* Another suit filed in U.S. District Court in New York charges the agencies with violations of the Racketeer Influenced and Corrupt Organizations Act (RICO) and fraudulent concealment of the company's financial condition. A similar charge has been made by a Senate panel, which suggested that First Executive Life may have been assisted by the rating agencies in presenting a misleading picture of financial stability. *Id.* (accusation made in a letter from the Senate panel to the U.S. Justice Department requesting an investigation of First Executive Life's failure).

95. See, e.g., Schachner & McLeod, *supra* note 57, at 31 ("[The rating agencies] did an inadequate investigation of Executive Life's condition and acted recklessly in maintaining its rating") (quoting Melvyn Weiss, an attorney who represents plaintiffs in New York and California in lawsuits against the rating agencies).

96. See Rhonda L. Rundle, *First Executive Chief, Auditor Sued for Fraud; California Insurance Official Charges S&P, Moody's, Best As Well As Milken*, WALL ST. J., Feb. 28, 1992, at A3; Kathy M. Kristof, *State Sues Over Failure of Exec Life*, L. A. TIMES, Feb. 29, 1992, at D1; Meg Fletcher & Michael Schachner, *Rating Firms, Others Sued in ELIC Collapse*, BUS. INS., Mar. 2, 1992, at 3; *California Insurance Commissioner Sues Former Executive Life Officers, Others*, BNA SEC. L. DAILY, Mar. 11, 1992, available in WESTLAW, BNA-SLD database.

97. Kristof, *supra* note 96.

98. *Id.*

99. See *Milken's Settlement to Help Policyholders*, J. OF COM., Mar. 11, 1992, at 9A.

100. Schachner & McLeod, *supra* note 57, at 31 (quoting John Grillos, general counsel for A.M. Best, that the public is free to attach as much weight as it wants to

of these ratings and the reliance on them by consumer and professional financial analyst alike, however, precludes disregarding ratings as insignificant opinions.¹⁰¹

The rating agencies' access to inside corporate financial information provides them with the means to make accurate and informed decisions regarding the need to change a rating. Their failure to downgrade First Executive Life is a prominent example of the failure of the rating agencies to downgrade ratings quickly enough.¹⁰²

B. Politics and Ratings

In addition to being criticized for being slow to change a rating, rating agencies have also been accused of influencing and being influenced by politicians.

(i) Being Influenced

In 1988, Massachusetts governor Michael Dukakis was the Democratic nominee for president of the United States. In March 1988, the fiscal problems of Massachusetts were headline news. The state's bonds fell as much as \$40 per \$1000 face value between January and March.¹⁰³ Standard & Poor's, however, delayed its downgrading almost until the end of the state's fiscal year on June 30, 1988.¹⁰⁴ Standard & Poor's attempted to justify its decision to wait with the excuse that they were waiting to see if the state would cure its fiscal problems.¹⁰⁵ In addition, despite worsening fiscal problems, the rating agencies did not downgrade the state's debt again until May 1989. Between May and July, the state's bond rating was downgraded more times than any period in the ten preceding years.¹⁰⁶ In July, Standard & Poor's downgraded the state's general obligation

Best's judgment).

101. *See, e.g., id.* ("What the hell does Best put out a rating for if not to advise people and guide them in their actions . . . You hold yourself out to be an expert in that area and now you tell me I shouldn't have been foolish enough to believe you?") (quoting an insurance company official who requested anonymity).

102. *See, e.g., id.* ("With Executive Life, you can blame the agencies. They're supposed to be insiders. They should know the company's financial structure better than anyone. Even people on the outside knew Executive Life was overweight with junk bond holdings'") (quoting Kim McCarrel of the Wyatt Co.).

103. Frederic M. Biddle, *Wall Street's Bond Busters: The Bay State Feels the Rating Agencies' Wrath*, BOSTON GLOBE, July 30, 1989, at 63.

104. *Id.*

105. *Id.* (quoting Richard Larkin, Standard & Poor's managing director).

106. *Id.*

bonds by two notches at once. This left Massachusetts with the lowest bond rating of every state except Louisiana.¹⁰⁷ The delay by Standard & Poor's in downgrading Massachusetts debt has led some to wonder whether its reasons were purely fiscal. The managing director of Standard & Poor's admitted that the rash of downgrades in the summer of 1989 was not the result of any new, unexpected financial developments, but was rather "a culmination of things that have been happening for the last nine months."¹⁰⁸ Nine months before the downgrades was autumn of 1988, when the presidential campaign was in its critical stage. Were the raters pressured by political considerations to delay their downgrades?¹⁰⁹

The downgrades in the summer of 1989 resulted in significantly increased costs of raising debt for Massachusetts. Some estimated that increasing the yield of bonds to compensate for their lower rating could cost the state \$20 million a year.¹¹⁰ An alternative to paying higher yields on bonds is to obtain private insurance on a bond issue. This effectively raises the bonds' rating to AAA, the highest rating available. Massachusetts did this in June 1989 after a scheduled sale of \$365 million of bonds was rated AA- by Standard & Poor's, and A by Moody's.¹¹¹ Obtaining private insurance for the bond issue raised its rating to AAA, and saved the state about \$3.6 million in interest over the 20-year life of the bonds.¹¹² However, the state had to pay \$1.6 million to obtain the insurance.

An earlier downgrade of the state's bond rating would not have saved the state money, at least in the short run. Indeed, it would have cost the state more because the state would have had to increase the yield on future bonds in order to attract new bond purchasers. However, it might have spurred the state legislature to more quickly cure the state's fiscal problems. The state might have saved money in the long run if stronger fiscal policy led to a quicker upgrade of the state's bond rating.

Another example of critics charging a rating agency with being influenced by a politician is New York's 1989 issuance of short-term debt. In April 1989, Moody's met with Mario M. Cuomo, governor of New York. New York was preparing to issue short-term debt to

107. *Id.*

108. *Id.*

109. See Zigas, *supra* note 9, at 108 ("Greenwich Partners' Sitzer notes that both S&P and Moody's maintained the rating of Massachusetts too long during the course of the 1988 Presidential elections, when the state's finances started to sour.").

110. Biddle, *supra* note 103, at 63. For an analysis of ratings as a determinant of net interest cost for municipal bonds, see Much, *supra* note 31, at 43-50.

111. Biddle, *supra* note 103, at 63.

112. *Id.*

finance the state's operations. Many people on Wall Street were expecting New York's rating to be downgraded at least one notch.¹¹³ Moody's, after a one-hour meeting with Governor Cuomo, however, decided to maintain its rating. Standard & Poor's likewise did not lower its rating.¹¹⁴

Because New York had a huge deficit and was experiencing a shortage of revenue, the rating agencies' failure to downgrade the state's rating stunned most observers. It led Howard Sitzer, head of municipal bond research at Greenwich Partners, to note that "[t]he perception can't be avoided . . . that Moody's bent to political pressure."¹¹⁵ Any suggestion of political influence is extremely significant because of the stakes involved. A downgrade of New York State's bond rating in January 1992 affected \$14.2 billion of issues.¹¹⁶

(ii) *Influencing*

In addition to receiving criticism for being influenced by politicians, the rating agencies have been criticized for influencing politicians. Rating agencies have tremendous power because increasingly debt-laden state and city governments are dependent on a rating from the agencies in order to raise money by issuing debt instruments such as bonds. Rating agencies often make suggestions to state legislators concerning ways to improve their rating. This can cause the legislators to change their budget and has caused some people to wonder whether the rating agencies have a disproportionate influence in government.¹¹⁷

Some have even charged that the rating agencies use the possibility of a downgrade to threaten legislators.¹¹⁸ Richard Larkin, managing director of Standard & Poor's, admits that his company uses the threat of a downgrade to influence state and city politicians:

113. Zigas, *supra* note 9, at 106.

114. *Id.*

115. *Id.*

116. See James C. Hyatt & Kevin Pritchett, *New York State Debt Rating Cut by Moody's Affects \$14.2 billion of Issues*, WALL ST. J., Jan. 7, 1992, at A2.

117. Adrienne Linsenmeyer, *Quoth the Rater, Nevermore: How the Rating Agencies are Telling Governors How to Spend Taxpayer Money*, FIN. WORLD, Feb. 18, 1992, at 24 ("Who elected the rating agencies to tell governors and mayors how to spend taxpayer money?").

118. See, e.g., Charles V. Zehren, *The New York Newsday Interview with Stadnyk & Larkin: Looking at Some Real Brutal Facts*, NEWSDAY, Feb. 26, 1992, at 79 (reporter's discussion with representatives of S&P's regarding politicians' influence on the raters and vice versa).

“We will say, ‘if this doesn’t happen, then the rating is in jeopardy.’”¹¹⁹ Standard & Poor’s has even been referred to as a fourth branch of the government.¹²⁰

The influence that the rating agencies have on state and local governmental decisions is very real, and strengthens the argument for some type of regulation. Rating agencies affect more than just the cost of interest; they influence which social policies will be cut and how the government will spend its money. A decision with such far-reaching implications merits some type of oversight.

C. Unsolicited Ratings

Another practical problem regarding rating agencies is the promulgation by both financial and insurance-company rating agencies of ratings which are not requested by the company being rated. Moody’s has been criticized for issuing unrequested ratings with regard to bond and commercial paper issuances. Many believe that these ratings, which are determined without access to the confidential corporate information normally available as part of the rating process,¹²¹ are just a means of increasing market share.

An example of Moody’s unsolicited ratings is American Southwest Financial Corporations’ 1987 issuance of a collateralized mortgage obligation (CMO). Just hours before the deal was finalized Moody’s issued an unsolicited rating.¹²² Moody’s rating was one notch lower than the rating given by Standard & Poor’s. Though Moody’s justified its lower rating on perceived serious structural difficulties in the issuance, others charged that Moody’s wanted to send a message that its approval was needed on any issuance of CMOs.¹²³

Another example of Moody’s unsolicited ratings involves the international debt market and a 1991 private placement issuance of \$150 million of seven-year notes by the French steelmaker, Usinor Sacilor. The company withdrew the offering after receiving an unwanted rating by Moody’s.¹²⁴ Again, critics complained that the rating was just a ploy by Moody’s to increase market share.¹²⁵

Leo O’Neill, president of Standard & Poor’s, is critical of the unsolicited ratings of Moody’s. However, Standard & Poor’s, while criticizing Moody’s for unsolicited ratings in the financial securities

119. Linsenmeyer, *supra* note 117, at 24.

120. Tom Buerkle, *His Judgments Rate with Budgetmakers*, CHI. TRIB., Apr. 29, 1990, at E13.

121. *See supra* note 65.

122. *See* Abby Schultz, *Wake-up Call for the Ratings Agencies: Unwanted By Issuers, Moody’s Renegade Ratings Roll a Once-Sleepy Industry*, INVESTMENT DEALER’S DIG., Oct. 28, 1991, at 18.

123. *Id.*

124. *Id.*

125. *Id.*

market, issues its own unsolicited ratings for insurance companies. Standard & Poor's, along with Weiss Research, another insurance-company rating agency, issues unsolicited ratings based solely on quantitative analysis of financial data.¹²⁶ Both rating agencies have been criticized because such ratings are generally lower than a normal claims-paying-ability rating.¹²⁷ Critics have charged Standard & Poor's with issuing these lower ratings¹²⁸ in order to extort insurance companies into requesting a more costly claims-paying-ability rating.¹²⁹ A claims-paying-ability rating costs between \$22,000 and \$28,000.¹³⁰ The idea behind the critics' allegations is that Standard & Poor's first issues its qualified solvency rating, which is lower (or at least appears so because a different scale is used) than its normal rating, and which has not been requested by the company being rated. Then Standard & Poor's publishes the rating, forcing the rated company to purchase the claims-paying-ability rating in order to eliminate the perception that the company has a lower rating.

The National Association of Insurance Commissioners (NAIC) has investigated claims that Standard & Poor's uses these ratings to coerce insurers into buying the more expensive claims-paying-ability rating.¹³¹ However, it has not issued any opinion on Standard &

126. These ratings are known as "qualified solvency ratings." See *Insurance Company Rating Agencies: A Description of Their Methods and Procedures; Condensation of Report Prepared by National Association of Insurance Commissioners, BEST'S REVIEW, LIFE/HEALTH INS. EDITION*, Mar. 1992, at 10, 107, 109-10 [hereinafter NAIC Report]. However, note that Weiss issues exclusively objective ratings, and never consults with or receives a fee from the insurance company. Standard & Poor's, on the other hand, issues both qualified solvency ratings and claims-paying-ability ratings.

127. *Id.* at 10.

128. Standard & Poor's uses a different scale for its qualified solvency ratings. The highest rating S&P's gives in a qualified solvency rating is BBBq, while its highest claims-paying-ability rating is AAA. Both ratings signify the same high level of financial strength. Thus, even if the rating S&P's issues as a qualified solvency rating is not actually lower than what its claims-paying-ability rating would be, consumers are likely to be confused by the qualified solvency rating and think it is lower. See Lisa S. Howard, *Examine Rating Agencies, Regulator, Insurers Suggest*, NAT'L UNDERWRITER, PROP. & CASUALTY/RISK & BENEFITS MGMT. EDITION, Sept. 9, 1991, at 1, 34 (consumers are confused when they see an AAA next to a BBBq, even though both ratings signify top quality); Lisa S. Howard, *Why Not Let the Market Rate the Rating Companies?*, NAT'L UNDERWRITER, PROP. & CASUALTY/RISK & BENEFITS MGMT. EDITION, Sept. 30, 1991, at 70 (solvency ratings are clearly misleading). See also Dauer, *supra* note 28, at S25 (confusion is being exacerbated by the growing number of rating agencies and suggests a uniform rating system be implemented).

129. NAIC Report, *supra* note 126, at 105.

130. *Id.*

131. See Cynthia Crosson, *NAIC Eyes 'Coercion' By Rating Firm*, NAT'L UNDERWRITER, PROP. & CASUALTY/RISK & BENEFITS MGMT. EDITION, Dec. 23, 1991, at 10.

Poor's practice of issuing these unsolicited ratings. The NAIC report¹³² undertook an examination of the rating practices of five insurance-company rating agencies. Unfortunately, the report did not provide any more information than is generally available to the public. Additionally, it did not attempt to evaluate the validity of the rating agencies' rating methods, nor did it attempt to assess the accuracy of the ratings by comparing ratings with actual performance.¹³³

The issuance of unsolicited ratings is important because of their effect on the market. If these ratings merely represent additional information on the insurers, then they are to be welcomed. However, if, as suggested, they lead to consumer confusion and force insurance companies to buy expensive claims-paying-ability ratings in an effort to dispel consumer confusion, then some solution such as regulation may be warranted. The problem of unsolicited ratings is much greater with respect to Standard & Poor's than with Weiss Research. Because Weiss¹³⁴ only issues one type of rating, based on purely objective financial data, danger of investor confusion is minimal. Investors who rely on Weiss' rating know that the rating is based solely on objective data, and also know that it is usually lower than a rating by one of the other rating agencies.¹³⁵ The risk of investor confusion, however, is much greater with respect to Standard & Poor's because of the firm's use of two types of ratings. Consumers are more likely to be confused by Standard & Poor's qualified solvency ratings, which use only objective data, and which use a different scale than the normal rating. This is true even if publication of the qualified solvency ratings is accompanied by a sufficient explanation of their nature.¹³⁶ Standard & Poor's qualified solvency ratings ought to use the same scale as their claims-paying-ability ratings.

D. Inaccuracy and Lack of Disclosure

Finally, the rating agencies have been criticized for being inaccurate and for failing to provide adequate disclosure of important financial information to investors who rely on the ratings. Some have

132. *Supra* note 126.

133. NAIC Report, *supra* note 126, at 110.

134. For a description of Weiss' rating methods, see NAIC report, *supra* note 126, at 109-10.

135. See, e.g., Eric N. Berg, *The Bad Boy of Insurance Ratings*, N. Y. TIMES, Jan. 5, 1992, at F1 (Weiss known for low ratings).

136. The publication of these ratings is currently accompanied by such an explanation. Yet, consumers are still confused by the ratings. See Howard, *supra* note 128, at 34 (the very nature of the qualified solvency ratings creates consumer confusion).

charged that the number of rating agencies is too small to be competitive, and thus results in inadequate disclosure to investors.¹³⁷ Others have charged the rating agencies with being inaccurate. Several studies have concluded that rating agencies are highly inaccurate in reporting terms of the bond covenant.¹³⁸ One study by Professors Asquith and Wizman compared information in Moody's Industrial Manual with the bond's actual prospectus and found that Moody's was incorrect twenty-one percent of the time.¹³⁹ The study found that important provisions of the bond indenture, such as debt-restrictive covenants and net worth covenants, were often omitted or misstated. Such omission or misstatement can cause serious problems that result in litigation.¹⁴⁰

Another study noted that the rating agencies were slow to downgrade companies that made announcements of leveraged buyouts.¹⁴¹ It found that Standard & Poor's changed its rating an average of five months after such an announcement.¹⁴² Additionally, one study found that there was a six to seven month lag between the rating change by one major rating agency and a subsequent change by the other major rating agency.¹⁴³ Finally, studies have found that, absent the recent refinements to the ratings scale,¹⁴⁴ Moody's and Standard

137. See, e.g., Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 817 (1985). See also John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 745-46 (1984) (rating agencies do not correct for inadequate market efficiency in the municipal bond industry, resulting in lack of full disclosure to investors).

138. The bond covenant or indenture is the legal agreement between the company issuing the bond and a trustee representing bondholders who will eventually buy the bonds. It is a detailed and complicated document, containing all the terms relating to the bonds being issued. See BELKAOUI, *supra* note 2, at 4.

139. Paul Asquith & Thierry Wizman, *Event Risk, Wealth Redistribution, and the Return to Existing Bondholders in Corporate Buyouts* 10-11 (1990).

140. For cases in which the bond rating agencies were sued due to such mistakes, see *Durning v. First Boston Corp.*, 627 F. Supp. 393 (W.D. Wash. 1986) (rating agency omitted fact that bonds were redeemable); *First Equity Corp. of Fla. v. Standard & Poor's Corp.*, 690 F. Supp. 256 (S.D.N.Y. 1988), *aff'd*, 869 F.2d 175 (2d Cir. 1989); *First Equity Corp. of Fla. v. Standard & Poor's Corp.*, 670 F. Supp. 115 (S.D.N.Y. 1987), *aff'd*, 869 F.2d 175 (2d Cir. 1989) (rating agency misstated bond provisions).

141. Arthur Warga & Ivo Welch, *Bondholder Losses in Leveraged Buyouts* 12 (June 1993 rev. ed.) (unpublished manuscript, on file with author).

142. *Id.*

143. Ederington & Yawitz, *supra* note 29, at 23-49 (citing E. Altman et al., *The Application of Statistical Classification Methods to Bond Quality Ratings*, in APPLICATION OF CLASSIFICATION TECHNIQUES IN BUSINESS, BANKING AND FINANCE (JAI Press 1981)).

144. For example, absent the pluses or minuses associated with a letter rating (e.g. "A+" vs. "A").

& Poor's issue different ratings on approximately ten to fifteen percent of new bond issues.¹⁴⁵ Furthermore, again disregarding refinements in the rating scale, rating agencies issue different ratings on about half of outstanding bonds.¹⁴⁶

On the other hand, many claim that the ratings are accurate. They cite studies which measure accuracy by the rate of default, and indicate that the default rate of highly rated debt is very low.¹⁴⁷ One possible retort to these findings is that measuring accuracy by rate of default is an imperfect measure of the accuracy and usefulness of ratings. While it is true that consumers purchase highly rated debt to avoid the risk of default, they also seek to avoid drastic downgrading of such debt. One of the main reasons consumers purchase highly rated debt is because they are risk-averse. Highly rated debt usually pays lower interest than debt with a lower rating, and consumers are willing to accept this lower rate of interest in exchange for their expectation,¹⁴⁸ induced by the high rating, that the debt is not risky.¹⁴⁹ Thus, most consumers would probably be very unhappy if the "AAA" rating of their bond was dropped to a "C". Yet, because such a downgrading of the bond's rating would not place the bond in default, information regarding such a significant downgrade would not be included in a study of the default rate of bonds.

Another reason that measuring the accuracy of ratings by the percent of default of rated debt may be an inadequate indication of the integrity of ratings is that a considerable amount of debt is not rated at all. Many issuers of debt do not seek a rating because of the cost, or because their credit represents higher risk that they prefer not to have exposed to the public market. Issuers of investment quality bonds¹⁵⁰ may actively seek ratings, while issuers of lower quality bonds may be pressured not to be rated. Moreover, the fact that much debt is unrated¹⁵¹ is important in that information regarding the debt's credit risk is not being conveyed to consumers. Because the majority of all default experience since the Great Depression has been in unrated bonds, those bonds that are most in need of credit

145. Ederington & Yawitz, *supra* note 29, at 23-49.

146. *Id.*

147. *Id.* at 23-17 (citing E. Altman & S. Nammacher, *High Yield Fixed-Income Default Experience*, Morgan Stanley & Co., Inc., *Fixed Income Division* (1985) (only 16 of 88 firms that defaulted between Jan. 1970 and Dec. 1984 were rated higher than "B")). See also Husisian, *supra* note 28, at 441.

148. Consumers, justifiably or not, rely heavily on a high rating. See Much, *supra* note 31, at 69 (quoting one consumer who likened an "AAA" rating to a stamp of approval from God).

149. See *supra* note 2.

150. An investment-grade rating means one of the four highest ratings. See BELKAOUI, *supra* note 2.

151. See, e.g., Much, *supra* note 31, at 39-43 (many municipal bonds are not rated).

review and publicity are frequently those that do not receive it.¹⁵² The rating agencies are currently addressing this problem by issuing unsolicited ratings. However, as has been shown, a question exists as to whether unsolicited ratings provide meaningful information or merely confuse and mislead consumers.¹⁵³

II. RATINGS AND THE SECURITIES AND EXCHANGE COMMISSION

A. *Use of Ratings to Exclude Structured Financings From the Definition of Investment Company*

The Securities and Exchange Commission relies upon rating agencies in many ways to exempt certain transactions from the disclosure requirements of federal regulations. For example, the SEC relies heavily upon rating agencies in new Rule 3a-7, a recent amendment to the 1940 Investment Advisers Act.¹⁵⁴ Rule 3a-7 excludes asset-backed securities, or structured financings, from the definition of an investment company under the Act. Structured financings are a financial technique in which assets, such as home mortgages, credit card receivables, and airplane and computer leases, are pooled. Then, securities are issued based on the strength of the asset pool. SEC Commissioner Richard Breeden has described the development of structured financing as one of the most far-reaching developments in United States financial markets in the last twenty years.¹⁵⁵

Significantly, assets that are eligible to back the structured financings are those rated, at the time of initial sale, in one of the four highest categories by at least one nationally recognized statistical rating organization.¹⁵⁶ Rule 3a-7, as originally proposed, would have

152. *Id.* at 112.

Because the recent default experience has been exclusively in unrated bonds, the quality of unrated credit becomes immediately suspect. As a class, unrated bonds represent an unfortunate commingling of those who cannot afford (or choose not to purchase) a rating, those who avoid ratings, and those to whom ratings are not given for a variety of reasons. The existence of this complex of unrated bonds is one of the major shortcomings of the present credit rating system.

Id.

153. *See supra* note 128 and accompanying text.

154. 17 C.F.R. § 270.3a-7 (1993). *See* Exclusion From the Definition of Investment Company for Structured Financings, 57 Fed. Reg. 56,248 (No. 229, Nov. 27, 1992).

155. *See SEC Approves New Exemption for Structured Financings from '40 Act*, 24 SEC. REG. & L. REP. 1799 (1992) (Commissioner Breeden noting that around half of all the mortgages in America are involved in structured financings).

156. 17 C.F.R. § 270.3a-7(a)(2) (1993).

limited eligible securities to those rated in one of the top two categories by a NRSRO.¹⁵⁷ This aspect of the amendment had been criticized by the Investment Company Institute (ICI). The ICI argued that the amendment relies too heavily on unregulated rating agencies to determine what type of securities may be offered to the public.¹⁵⁸

B. Ratings and Abbreviated Disclosure Requirements

In general, the Securities and Exchange Commission requires corporations wanting to issue new securities to file a registration statement that describes detailed financial information about the corporation and the security being offered. In 1982, the SEC introduced a new disclosure policy that allows certain companies to file substantially shorter registration statements than had been previously required.¹⁵⁹ Companies can use one of the new short registration forms if they are either widely followed by market analysts or if they possess an investment-grade rating for their debt or nonconvertible preferred stock.¹⁶⁰ Thus, regardless of whether the company can satisfy the requirement of being widely followed by security analysts, it can use Form S-3 as long as its debt is rated investment-grade by a rating agency.¹⁶¹ The SEC is relying on the rating agencies to investigate and assess the financial condition of the issuer.

157. See *SEC Proposes Excluding Structured Financings from '40 Act*, 24 SEC. REG. & L. REP. 797 (1992) (noting that SEC Commissioners Mary Schapiro and Richard Roberts expressed concern about the proposed amendment's heavy reliance on unregulated rating agencies).

158. See *ICI Blasts Structured Financing Draft, While Others Favor SEC's Rule Proposal*, 24 SEC. REG. & L. REP. 1414, 1415 (1992).

159. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 3.3, at 96-100 (2d ed. West 1990). The new disclosure system was promulgated under the premise that although information specific to the security being issued should always be disclosed in conjunction with the issuance, more general information about the registrant need not be disclosed if the information is already publicly available. The new integrated disclosure system established a three-tiered system of registration forms based on the registrant's reporting history and market following. Form S-1 is the traditional "long" form and requires complete registrant and transaction information to be provided in the prospectus. *Id.* § 3.3, at 98. Form S-2 requires less disclosure, and may be used by all registrants who have reported for three or more years under the Securities Act of 1933. *Id.* Form S-3 requires the least amount of disclosure. No information pertaining to the registrant need be included in the prospectus unless the company has experienced a material change. Only information specific to the security being registered need be disclosed. *Id.* To qualify to use Form S-3, the registrant must meet two requirements. First, the registrant must meet the three-year reporting requirement of Form S-2. Second, the registrant must meet a "market following" test under which it must either (1) have a minimum of \$150 million voting stock held by nonaffiliates (the "float"), or (2) have \$100 million float and an annual trading volume of at least three million shares. *Id.*

160. See 17 C.F.R. § 239.13(b)(2) (1993).

161. The SEC explicitly relied on the efficient capital market hypothesis (ECMH) in adopting both its abbreviated disclosure system and Rule 415 (the shelf registration process). See, e.g., Sec. Act Rel. 6499, 29 SEC. DOCK. 138, 141 (1983). Three forms of the ECMH exist. The weak form tests whether historical price data are fully reflected in

The SEC's reliance on ratings to justify abbreviated disclosure in registration statements is significant because it assumes the accuracy and reliability of ratings. If such ratings are not accurate, consumers face significant risks. One of the most important risks is that the ratings do not disclose adequate information. Some have charged that because the number of rating agencies is small, the market for ratings is not sufficiently competitive, resulting in a lack of full disclosure.¹⁶² Additionally, investors who purchase securities from a company that may use Form S-3 desire some information that will not be reflected by a rating.¹⁶³ These dangers are accentuated by

the price of a security. The semi-strong form tests whether all publicly available information is reflected in the price. The third form, the strong form, tests whether all information, including private information, is fully reflected in the price. See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970). Empirical studies have cast doubt on the legitimacy of the strong form. See 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 184 n.41 (3rd ed. 1989). See generally Ronald J. Gilson & Reinier H. Kraakman, *The Mechanics of Market Efficiency*, 70 VA. L. REV. 549 (1984). The ECMH is not universally accepted and has been criticized as an unproven and unreliable theory. See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (White, J., dissenting) (rejecting the majority's reasoning that an investor who relies on the integrity of a stock's price should be entitled to a presumption of reliance in a cause of action under § 10b-5 of the Securities Exchange Act of 1934).

Whatever the merits of the ECMH, realizing that the SEC is increasingly relying on it and on ratings to justify restricting the amount of information that must be disclosed in conjunction with securities transactions is important. For an analysis of the validity of this hypothesis as a justification for the SEC's new registration rules, see Gordon & Kornhauser, *supra* note 137, at 817. See also Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984); Marvin G. Pickholz & Edward B. Horahan III, *The SEC's Version of the Efficient Market Theory and Its Impact on Securities Law Liabilities*, 39 WASH. & LEE L. REV. 943 (1982).

162. Gordon & Kornhauser, *supra* note 137, at 817. Adequate disclosure of information is key to the federal securities system. See *Shores v. Sklar*, 647 F.2d 462, 483 (1981) ("[D]isclosure . . . is crucial to the way in which the federal securities laws function [T]he federal securities laws are intended to put investors into a position from which they can help themselves by relying upon disclosures that others are obligated to make.") (Randall, J., dissenting) (rejecting the fraud-on-the-market theory in an action under § 10b-5 of the Securities Exchange Act of 1934 because to do so would defeat the disclosure requirements of the Act).

163. Gordon & Kornhauser, *supra* note 162 (noting that ratings only provide information regarding the risk of default, and that information relevant to equity is also very important to the investor in debt securities).

Much of the recent legal commentary regarding bonds has focused on bondholder rights. See, e.g., Stephen Fraidin & Faith Stevelman, *Duties to Bondholders in Recapitalizations and Restructurings*, 23 INST. ON SEC. REG. 277 (1991); Dale B. Tauke, *Should Bonds Have More Fun*, 1989 COLUM. BUS. L. REV. 1 (1989); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. LAW 205 (1988); Albert H. Barkey, *The Financial Articulation of a Fiduciary Duty to Bondholders with Fiduciary Duties to Stockholders of the Corporation*, 20 CREIGHTON L. REV. 47 (1986); Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986).

recent SEC amendments to the Form S-3 registration process. On October 21, 1992, the SEC approved amendments to the shelf registration process¹⁶⁴ which make the Form S-3 registration process available to an additional 450 companies.¹⁶⁵ One of the most significant amendments is that eligible users of Form S-3 now need only file financial statements for the preceding twelve months, rather than the previously required thirty-six months.¹⁶⁶

The SEC's reliance on the rating agencies in allowing companies to use the Form S-3 registration statement poses two important dangers. First, investors purchasing securities registered under Form S-3 may not be receiving sufficient information regarding events which may significantly threaten the security of their investment. Furthermore, investors may actually be receiving inaccurate information by relying on the ratings if such ratings inaccurately state the provisions of a bond indenture.¹⁶⁷

These commentators have called attention to the fact that recent events such as leveraged buyouts and mergers have resulted in an expropriation of wealth from bondholders to stockholders. However, current remedies for bondholders have been limited. Thus, when company directors take actions which result in a transfer of wealth from bondholders to stockholders, the bondholders usually cannot recover unless the company actually defaults. This is a very inadequate remedy, and highlights the need for bondholders to receive accurate and reliable information regarding company actions that may increase the company's risk of default.

The rating agencies have responded, to a certain extent, to events such as leveraged buyouts and mergers (which, because they are frequently financed by risky debt, often increase the risk of default on previously issued bonds). For example, in July 1989, Standard & Poor's began to rate publicly held bonds by event risk. See Kenneth N. Gilpin, *S&P to Rate Protection on Takeovers*, N.Y. TIMES, July 22, 1989, at 31. In January 1990, Standard & Poor's announced that it would rate private placements by covenant protection. See John C. Coffee, Jr., *The Bondholder Puzzle*, N.Y. L.J., Mar. 22, 1990, at 7. However, the fact that it took Standard & Poor's almost five years from the time that event risk became a major threat to bondholders to implement such a system demonstrates that the market is not serving as an efficient check on the services provided by the rating agencies.

164. Shelf registration refers to the ability of an issuer to offer and sell securities at any time within two years after the effective date of the registration statement. 17 C.F.R. § 230.415(a)(3) (1992). Such subsequent "shelf" offerings must meet four requirements: the offering must be through the facility of a national exchange; the securities must be sold through one or more underwriters named in the prospectus; the securities must meet the requirements of Form S-3 (i.e. the securities must be widely followed by financial analysts); and the amount of registered securities, when voting stock, must not exceed 10 percent of the nonaffiliate float ("float" refers to the amount of stock outstanding and available for trading after reduction of large blocks of stock not likely to enter the market). See LOSS & SELIGMAN, *supra* note 161, at 359-60. See also LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 135-43 (2d ed. 1988) (detailing history of Rule 415).

165. See *SEC Approves Rule Changes on QIBS, Shelf Registration*, 24 SEC. REG. & L. REP. 1631 (1992).

166. *Id.* Additional amendments include allowing the offering of investment-grade asset backed financings on the S-3 Form and reduction of the minimum public float test for noninvestment-grade primary offerings from \$150 million to \$75 million. *Id.*

167. See *supra* note 139 and accompanying text.

These dangers are accentuated by Rule 415,¹⁶⁸ which allows a corporation that has filed a registration statement with the SEC to quickly issue securities for up to two years after the filing of the initial registration statement. If the corporation is eligible to use Form S-3 as its registration statement, it can issue its securities within forty-eight hours of the time it files the form. The company can issue its securities even if fundamental corporate changes have occurred subsequent to the filing of the registration statement.¹⁶⁹ The only requirement that the corporation must satisfy is the filing of periodic reports.¹⁷⁰ Thus, a real risk exists that a corporation could issue new securities based on an old rating that does not reflect significant new developments.

*C. Use of Ratings to Qualify Mutual Funds for Use of
Amortized Cost Method of Asset Valuation*

Another example of the SEC's reliance on ratings is Rule 2a-7 of the 1940 Investment Company Act.¹⁷¹ Rule 2a-7, an exemptive rule widely used by money market funds to value assets, allows the amortized cost of the securities in mutual fund portfolios to be used to establish the net asset value of fund shares.¹⁷² The rule's amortized cost method is less costly and more effective than having to compute the value of the mutual fund portfolios on a daily market basis.¹⁷³ To qualify for use of the amortized cost method, a short-term money market fund must be rated in one of the two highest categories by two nationally recognized statistical rating organizations.¹⁷⁴ If a security is downgraded to a rating that is not one of the top two ratings, the mutual fund is required to reassess the credit risk of the

168. 17 C.F.R. § 230.415 (1992).

169. However, these changes must be disclosed as post-effective amendments to the S-3 registration statement. The reporting of these changes is required by the Securities Exchange Act of 1934. 15 U.S.C. § 78(l) (1988). The Exchange Act requires that companies issuing securities on a national securities exchange file a registration statement for the security. *Id.* § 78(l)(a). Additionally, the Act requires all issuers of registered securities to file such additional current information as is needed to keep reasonably current all statements filed pursuant to section 12 of the Act. 15 U.S.C. § 78(m)(a) (1988).

170. Rule 415, in combination with Regulation S-K, requires a shelf registrant to provide the SEC with any information, such as a new debt issue, that amounts to a fundamental change in the information provided in the registration statement.

171. 17 C.F.R. § 270.2a-7 (1992).

172. See *SEC Issues Release on Amendments Affecting Money Market Funds' Assets*, 23 SEC. REG. & L. REP. 322, 322 (1991).

173. *Id.*

174. 17 C.F.R. § 270.2a-7(a)(5)(i) (1992). In a proposed amendment to Rule 2a-

security.¹⁷⁶ Thus, the SEC is relying on the rating agencies to both establish which securities are eligible for Rule 2a-7 and to determine when the credit risk of mutual fund portfolio securities should be re-evaluated. This is especially noteworthy because mutual fund securities are short-term securities. Therefore, if rating agencies are slow to downgrade a rating, the credit risk of securities held by mutual funds may not receive timely re-evaluation.

D. Use of Ratings to Exempt Qualified Institutional Buyers From the Disclosure Requirements of the 1933 Securities Act

The SEC also relies on ratings to justify reduced disclosure requirements under Rule 144A of the 1933 Securities Act.¹⁷⁶ Rule 144A exempts from the registration requirements of the 1933 Securities Act certain reoffers and resales of securities of foreign and domestic issuers. The exempted transactions involve private transactions in which the purchaser is a "qualified institutional buyer" (QIB).¹⁷⁷ The presumption is that these private transactions do not pose the same danger as a public offering, and that qualified institutional buyers are parties able to fend for themselves in the marketplace.¹⁷⁸ A major obstacle, however, to effective implementation of Rule 144A is determining who is a QIB. To facilitate this determination, the SEC has declared that sellers may rely on a list of QIBs published by Standard & Poor's.¹⁷⁹ Thus, the SEC is relying on a rating agency to qualify a purchaser to engage in a transaction exempted from traditional disclosure requirements.

7, the SEC in April 1991 recommended that the mutual fund security should only have to be rated in one of the highest two categories by one rating agency. *See SEC Would Exempt Tax-Exempt Funds from Need to Approve Unrated Purchases*, 23 SEC. REG. & L. REP. 527, 527 (1991) (stating as a reason for the proposed amendment the burden of requiring a rating by two nationally recognized statistical rating organizations (NRSROs), because many securities are rated by only one NRSRO).

175. 17 C.F.R. § 270.2a-7(a)(5)(i) (1992).

176. 17 C.F.R. § 230.144A (1992). Rule 144A was adopted by the SEC on April 30, 1990. *See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145*, 55 Fed. Reg. 17,933 (1990).

177. Any entity that owns and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the entity may constitute a qualified institutional buyer. 17 C.F.R. § 230.144A(a)(i) (1992). *See also* J. WILLIAM HICKS, 7B EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 § 10A.03[3] (1993).

178. *See* Hicks, *supra* note 177, § 10A.01[1].

179. *See* Standard & Poor's Corporation, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,021, at 78,893 (July 8, 1991) (SEC grants Standard & Poor's request that a seller may rely on list of QIBs published by S&P's in its Corporation Records). *See also Sellers May Rely on S&P List for Rule 144A Purposes, Staff Confirms*, 23 SEC. REG. & L. REP. 1095 (1991).

III. RECOMMENDATIONS

This Comment has sought to examine the current status and role of rating agencies and ratings in the financial securities and insurance markets. This examination has revealed that rating agencies are often slow in changing ratings, that consumers are confused due to lack of uniform standards, and that unsolicited ratings are being published. Because a rating is often the main factor upon which both institutional and private investors rely when making an investment decision, and because the Securities and Exchange Commission increasingly relies on ratings to justify exempting issuers from disclosure requirements in connection with securities transactions, problems related to ratings agencies merit serious consideration.

One possible solution to the problems currently affecting the market for ratings is to allow a personal cause of action against the rating agencies and change the standard of care applicable to rating agencies from recklessness to negligence.¹⁸⁰ Although conducting a full examination of this option is beyond the scope of this Comment,¹⁸¹ for reasons briefly mentioned below, this possible remedy should be rejected.

First, changing the standard of care that rating agencies must exercise from recklessness to negligence might not lead to an increased level of care exercised by the rating agencies. Instead, rating agencies might refuse to rate more risky debt.¹⁸² Thus, an increased standard of care might not result in improved diligence in the rating process utilized by the rating agencies.

A second reason why heightening the standard of care should be rejected is that because the threat of expanded liability may lead to the refusal of rating agencies to rate risky debt, less information may

180. Currently, the rating agencies, as members of the media, are not held liable unless they act recklessly. See, e.g., *First Equity Corp. of Fla. v. Standard & Poor's Corp.*, 869 F.2d 175 (2d Cir. 1989); *Pittman V. Dow Jones & Co.*, 662 F. Supp. 921 (E.D. La. 1987), *aff'd*, 834 F.2d 1171 (5th Cir. 1987).

181. For a more detailed analysis, see Husisian, *supra* note 28, at 430-46 (rejecting the idea of changing the standard of care from recklessness to negligence).

182. The rating agencies' potential refusal to rate risky debt due to fear of increased liability may be explainable in terms of their imperfect ability to transfer the cost of increased potential liability to the company being rated. Rating agencies are paid by the company whose debt is rated. However, this rating is disseminated to many investors who obtain a benefit from the rating because the rating aids their investment decision. The rating agency, though, may not be able to increase the cost of a rating sufficiently to fully compensate itself for the benefit conferred upon these "free-rider" third-party investors. But, assuming they can, the price of a rating might be placed outside the reach of many companies. Thus, rating agencies may simply choose not to rate risky debt.

be provided to investors. As previously mentioned, companies issuing risky debt frequently choose not to have the debt rated.¹⁸³ If changing the standard of care of rating agencies leads to a decreased willingness of rating agencies to rate the risky debt of companies that do desire a rating, then the result may be decreased protection of investors due to decreased information.¹⁸⁴ The debt of companies that perhaps most needs to be rated — because the company issuing the debt is young or small or risky in its business strategy — may not receive a rating.

A second solution to the present problems with ratings is limited regulation. Current problems indicate that competition is not serving as a sufficient means for regulating the market for ratings. Competition provides no incentive for the rating agencies to downgrade a rating in a timely manner, nor has it served to discourage unsolicited ratings. Regulation of the entire industry, however, is undesirable. Too much regulation inhibits economic growth by increasing costs and making capital harder to raise.¹⁸⁵ Given the fact, though, that ratings are extensively relied upon by the SEC to reduce regulatory requirements, rating agencies must receive at least minimal oversight.¹⁸⁶

183. See *supra* note 152 and accompanying text.

184. Compare the analogous situation of the liability of accountants to third-party creditors for negligent audits. Traditionally, accountants were only liable for negligent conduct towards a party with whom they were in contractual privity. *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931). Some courts, stressing goals of deterrence and risk-spreading, have held accountants liable under a negligence standard to third parties whose reliance on the accountant's audit was foreseeable. *Touche Ross & Co. v. Commercial Union Ins.*, 514 So. 2d 315 (Miss. 1987); *International Mortgage Co. v. John P. Butler Acct. Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986); *Rosenblum, Inc. v. Adler*, 461 A.2d 138 (N.J. 1983); *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361 (Wis. 1983).

However, the result of this expanded liability was different from that intended. Accountants, rather than improving the overall level of care, responded by limiting their audits to "safe" companies. See John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1967 (1988).

185. In a survey of 653 corporate executives during the second half of 1991, government regulation was identified as the top concern for more than 50% of all chief executive officers. *Corporate Executives Surveyed Say Government Regulations Top Concern*, 24 SEC. REG. & L. REP. 207, 208 (Feb. 14, 1992). In his State of the Union address Jan. 28, 1992, President Bush requested a 90-day moratorium on new government regulations in an effort to reduce burdens on businesses. See *Bush Directs Regulatory Agencies to Review Pending Rules to Help Economy*, 24 SEC. REG. & L. REP. 102, 102 (1992). Some commentators even saw Mr. Bush's moratorium as a potential chance to challenge the constitutionality of all independent regulatory agencies. See L. Gordon Crovitz, *Rule of Law: Which Boss Should a Poor Regulator Believe?*, WALL ST. J., Feb. 12, 1992, at A21 (speculating that if one of the agencies such as the EPA or SEC refused to comply with the moratorium, the Justice Department could challenge the constitutionality of the agency).

186. See Vicky Stamas, *Only a Minority Backs Creating More Rules as Market Debates Rating Agency Role*, BOND BUYER, Aug. 31, 1992, at 1 (Craig Tyle, V.P. of the Investment Company Institute, argues that if federal securities laws are radically changed to make rating agencies quasi-regulatory bodies, then greater oversight of rating

What is needed is limited regulation directed at the few serious problems afflicting rating agency activity. The rating agencies should continue to make their own decisions, with a regulatory agency's role limited to suggesting re-evaluation of a rating and imposing sanctions when appropriate. Because of the differences in the financial securities marketplace and insurance industry, discussion of the proposed regulation will be separated into two subparts: subpart A: Regulation of Financial Security Ratings; subpart B: Regulation of Insurance Company Ratings.

A. Regulation of Ratings of Financial Securities

Because a rating of a financial security accompanies issuance of the security, these ratings could be regulated by the Securities and Exchange Commission, or by a commission set up by the SEC. The SEC should be given explicit statutory authority to (1) establish standards for the designation of nationally-recognized statistical rating organizations and require all NRSROs to register with the SEC; and (2) promulgate rules governing NRSROs.

(i) Establishing Standards for Designation of NRSROs

Currently, the SEC's Division of Market Regulation governs the designation of NRSROs through the issuance of no-action letters. If a rating agency wishes to be designated a NRSRO, it sends a letter to the SEC requesting that the SEC recommend no regulatory enforcement action against the rating agency if it is designated a NRSRO.¹⁸⁷ The Securities and Exchange Act of 1934, however, does not set standards for qualifying a rating agency as a NRSRO.¹⁸⁸ Moreover, the SEC's Division of Market Regulation has not developed formal standards for such designation, relying instead primarily on market acceptance of rating agencies in designating NRSROs.¹⁸⁹

agencies is warranted).

187. For an example of such a letter, see IBCA Limited, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,624, at 77,824 (Oct. 11, 1990); see also *U.K. Firm May Be Used as Rating Agency for Compliance With Net Capital Rule*, 22 SEC. REG. & L. REP. 1560 (1990).

188. See *U.K. Firm May Be Used as Rating Agency for Compliance With Net Capital Rule*, *supra* note 187.

189. In deciding whether to designate a rating agency a NRSRO, the Division of Market Regulation has stated that the most important criterion is whether the agency's ratings are nationally recognized by preeminent users of rating services as credible and reliable. See *Colorado Concern Not Qualified to be Designated NRSRO, Staff Advises*, 23 SEC. REG. & L. REP. 542, 542 (1991). The Division of Market Regulation has stated

However, given the SEC's heavy reliance on NRSROs, it should establish minimum requirements for the designation of such agencies, rather than predominantly relying on market acceptance. The designation of NRSRO gives to a rating agency powerful marketability.¹⁹⁰ A corporation will pay more for a rating from a NRSRO because such a rating is capable of exempting the corporation from costly and tedious compliance with federal disclosure requirements. Legislation should be passed which would give the SEC explicit authority to establish minimum requirements for such designation.

Furthermore, all NRSROs should be required to register with the SEC. SEC Commissioners Mary Schapiro and Richard Roberts have advocated such a requirement.¹⁹¹ Additionally, Representative John Dingell, Chairman of the House Energy and Commerce Committee, supports regulation of rating agencies and has indicated his desire to draft such legislation.¹⁹² Currently, all NRSROs must register with the SEC as investment advisers under the 1940 Investment Advisers Act. Given the questionable legality of this requirement,¹⁹³ though, legislation which would give the SEC explicit power to require such registration is desirable. Registration of NRSROs would enable the SEC to monitor the rating agencies and ensure that their practices result in accurate and reliable ratings. At a minimum, all NRSROs should be compelled to disclose to the SEC their rating

that it also relies on other factors such as the agency's financial resources, its staffing, its reputation for integrity in the marketplace, its rating procedures, and its compliance with procedures designed to prevent misuse of nonpublic information. *Id.* at 542-43. In failing to recognize Dealer and Bondholder Services, Inc. (DBS) as a NRSRO, the Division of Market Regulation relied heavily on the fact that DBS was small and not widely accepted in the marketplace. *Id.* at 543. *Cf.* Aaron Pressman, *Dingell May Draft New Law Regulating Rating Agencies*, INVESTMENT DEALERS' DIG., May 11, 1992, at 5 (noting that SEC Commissioner Richard Roberts has suggested four criteria that an agency should meet to be considered a NRSRO: national recognition by the marketplace as being credible and reliable; a thorough, credible, and comprehensive rating methodology; unbiased analysts free from outside pressures; and timely and useful ratings).

190. Additionally, the purchaser of a rating from a NRSRO gains marketability. Purchasers of ratings often use the rating in their advertising. *See, e.g.*, the advertisement of Municipal Bond Investors Assurance Corporation, WALL ST. J., Jan. 14, 1993, at A13 ("Both Moody's and Standard & Poor's give their highest rating, Triple-A, to every bond we cover.").

191. *Roberts, Schapiro Seek Legislation Giving SEC Power Over Rating Agencies*, *supra* note 25, at 1269 (noting that rating agencies have become an integral part of the federal regulatory scheme); *Debt Rating Agencies Should Be Subject to More SEC Regulation, Roberts Asserts*, 24 SEC. REG. & L. REP. 485, 485-86 (1992). However, SEC Chairman Richard Breeden opposes any regulation of rating agencies. *See Debt Rating Agencies: Breeden Sees No Need For Legislation Giving SEC Power Over Rating Agencies*, 24 SEC. REG. & L. REP. 1299, 1299 (1992) (stating his opinion that rating agencies are already subject to strong market discipline).

192. *SEC: Dingell Asks SEC to Help Draft Rating Agencies Regulation Bill*, 24 SEC. REG. & L. REP. 684, 684-85 (1992); *see also SEC: Dingell Seeks Views on Bank Tying, Rating Agencies, Amex Listing Procedures*, 24 SEC. REG. & L. REP. 1089, 1089 (1992).

193. *See infra* note 205 and accompanying text.

methodology and guidelines for review of ratings.

(ii) *Promulgation of Rules Governing NRSROs: The Writ of Review*

Legislation concerning rating agencies should grant to the SEC authority to pass rules governing the conduct of rating agencies. These rules should be primarily advisory. For example, the SEC could pass a rule enabling it to issue a "Writ of Review." If the Commission believes that a rating agency is unduly delaying changing a rating, it would issue a Writ of Review to the rating agency, suggesting that the rating agency re-evaluate the rating. The rating agency would be free to disregard the writ. However, failure to re-evaluate would raise a presumption of negligence. Complying with the writ would raise a presumption of due care.

Anyone would be permitted to petition the commission to issue a writ, but the commission would possess absolute discretion to issue or not issue the writ. For example, a corporation could petition the commission to issue a writ if it believed that its rating should be upgraded.¹⁹⁴ Or, an individual investor or consumer group could petition the commission to issue a writ if they suspected a downgrade was necessary. Finally, in many instances the SEC might issue a writ based on its access and review of a security issuer's information. For example, consider the SEC's enforcement action against Presidential Life Corporation.¹⁹⁵ The SEC sanctioned Presidential Life for its 1989 improper accounting of the value of junk bonds and other securities. The junk bonds alone had declined in market value by about \$20.7 million.¹⁹⁶ The result was that Presidential Life's pre-tax income for 1989 was overstated by about thirty-seven percent. In a case such as this, the SEC could, along with bringing enforcement action as it did, issue a Writ of Review to the rating agency. Here, it was not necessary because the bonds were rated

194. Although complaints that a rating agency has improperly withheld a rating increase are less frequent than complaints of slowness in downgrading a rating, they do exist. For an example of such a complaint with respect to state bonds, see Stan Hinden, *Credit Raters Questioned by States; Treasurers Meet Firms' Analysts*, WASH. POST, July 27, 1991, at F1 (state treasurers questioned whether rating agencies' failure to upgrade was based on weak economic climate of region, rather than conditions in their particular state). See also Susan Pulliam, *A.M. Best, Insurer-Rating Firm, Refines Its System Amid Criticism It Acted Late*, WALL ST. J., Jan. 14, 1992, at B5 (many insurance companies have complained of unnecessary downgrades).

195. See *Insurance Company Charged by SEC for Junk Bond Accounting Practices*, 24 SEC. REG. & L. REP. 1537, 1537 (1992).

196. *Id.*

noninvestment grade by Moody's. Yet, these events do suggest the type of situation in which the SEC could issue a Writ of Review if the rating had not been changed.

Although this type of situation may seem farfetched, it is exactly what happened with First Executive Life. Despite the fact that California insurance regulators forced First Executive Life to reduce its reported portfolio value, due largely to drastic decreases in the value of its huge junk bond holdings, the rating agencies did not subsequently downgrade First Executive Life's rating.

(iii) *Standard of Review and Sanctions*

If the rating agency complies with the writ by reviewing the rating, yet does not change the rating, the Commission may wish to proceed further against the rating agency if it believes the agency's review was negligent. If it chooses to do so, the rating agency will enjoy a presumption of due care. This may be rebutted by the Commission establishing negligence or conflict of interest. The standard should be the same standard used for all negligence cases. Here, it would be that duty of care owed by an ordinary, reasonable rating agency in similar circumstances.¹⁹⁷ If the Commission establishes the rating agency's negligence, it would have discretion to impose economic fines on the rating agency or, in special circumstances, to issue injunctive orders.

B. *Regulation of Ratings of Insurance Companies*

Regulation of insurance-company ratings would be similar to that of the financial securities market. The NAIC or an independent commission would oversee regulation. Here, however, a need perhaps exists for establishing minimum standards in assessing the solvency of insurance companies. Though the strength of an insurance company's investment portfolio is a dominant measure of its solvency, new factors should be included when necessary.¹⁹⁸ Recently, rating agencies have decided to include consumer confidence as a factor in rating insurance companies.¹⁹⁹ These minimum standards are necessary because the insurance industry plays a crucial role in the nation's financial system. Consumer confidence in the industry has

197. Because the standard is a theoretical one, it would be sufficient even if no other rating agency was acting reasonably. The standard is a normative one, and thus specifies how an agency ought to act, not how other agencies are in fact acting.

198. For example, in the 1970s insurance companies began issuing new variable-rate life insurance, in which the interest rate was tied to market rates. This forced the insurance companies to seek new investment options when market rates increased. Berg, *supra* note 47, at A1. An event such as this should cause the rating agencies to scrutinize the safety of the new investment and include such evaluation in their rating process.

199. See, e.g., Schachner & McLeod, *supra* note 57, at 1 (A.M. Best, seeking to

been substantially eroded due to recent failures of insurance companies.

The minimum standards would not be mandatory, but would be considered in evaluating the rating agency's action if the commission pursued action against the rating agency for failure to change a rating after being issued a writ. Compliance with the minimum standards would raise a presumption of due care. Action which did not comply with such minimum standards would raise a presumption of negligence.

Another important aspect of regulation of insurance company rating agencies is that communication and cooperation with state insurance regulators are needed. Although most insurance companies are huge, multi-billion-dollar companies that conduct business in many states, no national insurance law exists.²⁰⁰ Regulation is left to the individual states. State regulators, however, often do not communicate with one another. When First Executive Life of California was forced by state regulators to reduce its reported net worth by \$180 million in 1986, state regulators did not force it to change its financial statements in other states where it did business, nor did they communicate this important information to state regulators in those other states.²⁰¹ With this type of poor performance by, and cooperation among, state insurance regulators, the function of rating agencies assumes added importance. Rating agencies are needed even more in the insurance industry than in the financial securities industry to warn consumers about insurers that are on shaky financial

assess an insurer's ability to withstand a "run on the bank" by jittery policyholders wanting to cash in their insurance contracts, announced in 1991 that it had added a "policyholder confidence factor" to its rating analysis).

200. In *Paul v. Virginia*, 75 U.S. (8 Wall.) 168, 183-86 (1868), the Supreme Court held that insurance contracts were local transactions, and not subject to federal regulation under the Commerce Clause, Article I § 8 of the U.S. Constitution. However, *Paul* was overruled in *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944), which held that an insurance contract between an insurer and a policyholder from different states was interstate commerce and thus subject to federal regulation. However, despite Congress' enactment of the McCarran-Ferguson Act of 1945, 15 U.S.C. §§ 1011-1015 (1992), state regulation of the insurance industry predominates. The McCarran-Ferguson Act states that "Congress declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States." *Id.* § 1011.

201. Kristoff, *supra* note 64. See also Perlmutter & Russo, *supra* note 85, at 20 ("[E]ffective national oversight of the insurance industry does not exist primarily because regulators fail to work together or take timely, appropriate action when a problem insurer is identified . . . [T]roubled insurers are able to operate for extended periods — often years — without being forced to resolve their problems.").

ground.

The commission could serve an important communicative purpose. Even if the commission decides not to issue a Writ of Review, it could alert state regulators to perceived dangers. State regulators could then monitor more closely the insurance company, or take independent action.

IV. FIRST AMENDMENT CONCERNS

Any proposed regulation of rating agencies raises significant issues concerning the First Amendment's guarantee of the freedom of the press. Although a full discussion of this issue is impossible in this Comment, a few of the more serious issues must be examined. These issues are: (A) Is the current mandatory registration with the SEC of NRSROs as investment advisers under the 1940 Investment Advisers Act valid?; Does mandatory registration of rating agencies with the SEC raise serious First Amendment concerns?; (B) Does further regulation of rating agencies raise serious First Amendment concerns?

A. Mandatory Registration of Rating Agencies With the SEC

Currently, all NRSROs must register with the SEC as "investment advisers," as that term is used in the 1940 Investment Advisers Act.²⁰² Further, it has been suggested that any proposed legislation of rating agencies include a provision explicitly mandating such registration.²⁰³ The issue is whether such mandatory registration is required under the Investment Advisers Act, and whether it would be valid under the First Amendment if included in future legislation.

Although all NRSROs currently are required to register with the SEC, a challenge of this requirement by a NRSRO would probably be successful. In *Lowe v. SEC*,²⁰⁴ the United States Supreme Court held that the publisher of an investment newsletter was within the exclusion of the Investment Advisers Act for the publisher of any bona fide newspaper, news magazine, or financial publication of general circulation,²⁰⁵ and thus not subject to the registration requirements of the Act.²⁰⁶ Because the publication of ratings is similar to

202. 15 U.S.C. §§ 80b-1 to 21 (1988).

203. See *supra* note 191 and accompanying text.

204. 472 U.S. 181 (1985).

205. 15 U.S.C. § 80b-2(a)(11)(D) (1988).

206. 472 U.S. at 210-11. Justice White, however, disagreed with this conclusion, arguing that such a newsletter should fall within the definition of investment adviser under the Act. He stated that "[n]othing in the legislative history of the statute supports a construction of 'investment adviser' that would exclude persons who offer investment advice only through such publications as newsletters and reports." *Id.* at 219 (White, J., concurring).

the publication of the financial newsletter involved in *Lowe*,²⁰⁷ rating agencies probably also qualify for the Act's exemption for publishers of bona fide financial publications of general circulation. Thus, the SEC probably could not continue to require rating agencies to register with it under the Act if challenged on the issue.

A further issue is whether a provision in future legislation mandating similar registration with the SEC would pass constitutional muster. Although such a requirement would raise constitutional issues, it would clearly be constitutional.²⁰⁸ Requiring rating agencies to register with the SEC is a minimum burden on rating agencies and does not restrict the publication of ratings.

B. Further Regulation of Rating Agencies

The real First Amendment issues are raised by regulation that imposes further requirements than just registration. Although the Supreme Court did not decide *Lowe* on constitutional grounds,²⁰⁹ Justice White stated in his concurrence, which was joined by Chief Justice Burger and Justice Rehnquist, that he would have decided the case on First Amendment grounds. Justice White distinguished between the giving of personalized advice to one particular client and the general publication of impersonal advice to the public; it is the regulation of the latter that raises serious First Amendment concerns.²¹⁰

Although the regulation of rating agencies would raise First Amendment concerns, the standard of review that would be applied

207. See *In Re Scott Paper Co. Sec. Litig.*, 1992 WL 379287 (E.D. Pa. 1992). The court noted that "S&P's publications have all the attributes identified by the Supreme Court in *Lowe* as indicative of the press. S&P publishes periodicals with a regular circulation to a general population Furthermore, unlike stockbrokers or personal investment advisors, S&P does not advise specific clients on their purchases or sales and has no personal interest in whether its subscribers actually purchase the securities which it rates." *Id.* at **4.

208. See *Lowe*, 472 U.S. at 225 n.8 ("Similarly, the application of the Act's reporting requirements, 15 U.S.C. § 80b-4, to investment advisers whose activities are restricted to publishing would not appear to raise serious First Amendment concerns.") (White, J., concurring).

209. As mentioned, the Court decided the case through interpretation of the Investment Advisers Act's exemption for publishers of bona fide financial publications of general publication. See *supra* note 204 and accompanying text.

210. 472 U.S. at 232 ("Where the personal nexus between professional and client does not exist, and a speaker does not purport to be exercising judgment on behalf of any particular individual with whose circumstances he is directly acquainted, government regulation ceases to function as legitimate regulation of professional practice with only incidental impact on speech; it becomes regulation of speaking or publishing as such").

is unclear. However, for reasons explained below, the limited regulation proposed in this paper would probably survive any constitutional challenge. Uncertainty exists with respect to what standard of review would be applied because no court has ever been squarely presented with the issue of regulation of rating agencies.²¹¹ The Supreme Court's decision in *Lowe*, however, provides a clue as to what standard might be applied. On the one hand, the activity of the rating agency might be considered commercial speech. In that case, a reduced level of scrutiny would be applied. Justice White indicated that under this standard of review, regulation will be upheld so long as a significant government interest is furthered by the regulation.²¹² Furthermore, Justice White stated that the government interest at issue in *Lowe*, the protection of the public from disreputable investment advisers,²¹³ was legitimate. The government's interest at stake in the legislation of rating agencies proposed in this Comment, namely, the assurance of the integrity of United States capital markets and the protection of the public from inaccurate ratings, is similarly a legitimate and significant government interest that would survive a First Amendment challenge.

Justice White did not reach the issue of whether a publication of a financial newsletter would be treated as commercial speech and thus receive reduced protection, or whether it would be entitled to full First Amendment protection.²¹⁴ Instead, he decided that the SEC's proposed injunction against Lowe's publication of the financial newsletter was a prior restraint against speech, and thus presumptively invalid.²¹⁵ Central to Justice White's opinion was that the SEC sought to enjoin the publication of Lowe's newsletter based upon Lowe's past conduct, rather than basing such injunction on affirmative proof that Lowe's newsletter was false or misleading.²¹⁶ Thus, Justice White would have refused the SEC's request for an injunction even if a reduced commercial speech standard of review had been used.²¹⁷

The action called for by the SEC in the legislation called for in this Comment, however, is inapposite to the SEC action at issue in

211. See, e.g., *In Re Scott Paper Co. Sec. Litig.*, *supra* note 207, at ***3 ("We have found no case, and the parties have cited none, which analyzes whether S & P or similar organizations constitute the press under the First Amendment.").

212. *Lowe*, 472 U.S. at 233 (quoting *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626 (1985)).

213. *Id.* at 234 ("The interest here is certainly legitimate: the Government wants to prevent investors from falling into the hands of scoundrels and swindlers.").

214. *Id.*

215. *Id.*

216. *Id.* at 234-35.

217. *Id.* at 235.

Lowe, and poses less drastic means to further the legitimate government interest in protecting investors. The legislation proposed here would not be considered a prior restraint. Unlike the SEC's action in *Lowe*, which was based upon a concern for possible future abuse by *Lowe*, the proposed legislation of rating agencies outlined in this Comment would authorize SEC action only if objective information indicates that events in the past suggest that a re-evaluation of a rating is desirable and has not been forthcoming. Thus, the issuance of a Writ of Review by the SEC would not be considered a prior restraint of speech.

Further, even if a heightened level of scrutiny is applied to regulation of rating agencies, the regulation proposed in this Comment would withstand a constitutional challenge. The proposed legislation is narrowly tailored and furthers a significant government interest.²¹⁸ Thus, whether the activity of rating agencies is considered commercial speech or regular speech,²¹⁹ the legislation proposed here complies with the mandate of the First Amendment²²⁰ that Congress shall make no law abridging the freedom of speech, or of the press.

V. CONCLUSION

This Comment has examined various allegations of the failure of rating agencies to downgrade quickly enough, political influence, inaccuracy and lack of disclosure, and unsolicited ratings. Ratings are important in the promulgation of federal regulations, and are used by the SEC to justify exempting issuers of securities from the registration and disclosure requirements of federal regulations. Even if serious current problems with rating agencies were not prevalent, the extreme reliance placed by the SEC on ratings merits the limited regulation of rating agencies outlined in this Comment.

Rating agencies, as members of the media, enjoy the protection of the First Amendment. The First Amendment, however, has always

218. See *id.* at 236 ("I see no infirmity in defining the term 'investment adviser' to include a publisher like petitioner, and I would by no means foreclose the application of, for example, the Act's antifraud or reporting provisions to investment advisers (registered or unregistered) who offer their advice through publications.") (White, J. concurring).

219. See *In Re Scott Paper Co. Sec. Litig.*, *supra* note 207. The court mentioned, without giving reasons for its conclusion, that the publication of a bond rating by Standard & Poor's is not commercial speech. *Id.* at **4. However, the court noted that forcing Standard & Poor's to disclose information regarding its discussions with the company whose bonds it rated might not chill free speech as much as forcing some other entity or member of the press to disclose information asserted to be privileged, and thus might not raise as significant a First Amendment issue. *Id.*

220. U.S. CONST. amend. I.

sought to achieve a balance between the free flow of information and prevention of harm to others. If rating agencies only had an impact on sophisticated investors well-equipped to guard against injury caused by negligently disseminated information, then the current liability of rating agencies would not merit reconsideration. However, the opposite is true. Individual investors in both the financial securities and insurance industries rely daily on ratings to make investment decisions. Furthermore, the SEC relies heavily on the quasi-regulatory rating agencies to restrict the amount of financial information disseminated to the public. Given the current situation, the limited regulation suggested in this Comment is needed to ensure that the use of ratings in the federal securities laws continues to promote protection of individual investors.

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