ARTICLES

THE ROLE OF THE SEC IN THE REGULATION OF THE RATING AGENCIES: WELL-PLACED RELIANCE OR FREE-MARKET INTERFERENCE?

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Introduction

Rating agencies have been rating securities in the United States since the beginning of this century.[1] Creating an efficient interface between investors and issuers, rating agencies assist capital markets by, first, reducing individual investors' information costs in conducting their own securities research and, second, by reducing the cost of capital paid by issuers.[2] Efficient capital markets need accurate information to insure optimal choices by investors and to assure that money flows to those who are able to use it most effectively.[3] Securities research exhibits many of the charac-

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1 *See* Gregory Husisian, *What Standard of Care Should Govern the World's Shortest Editorials?: Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 412 nn. 5, 6 (1990). Moody's Investor Service Inc. began to rate railroad bonds in 1900, and industrial bonds in 1914, *id.* at 412, Poor's, which eventually merged to become Standard & Poor's, started to rate securities in 1922. *Id.* Standard Statistics began a similar practice the following year. *Id.*

2 *See, e.g.,* Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 786 (1985):

> [L]egal rules should discourage institutional investors, acting as fiduciaries, from expenditures on securities research. But the claim also leads to a curious paradox: the market will remain efficient only if most market participants believe it is not and accordingly engage in the securities research necessary to create efficiency. This conundrum raises a third concern to complement those of speculative and allocational efficiency already noted. A market, efficient or not, should be in informational equilibrium: investors should not only lack incentive to change their portfolios, they should also have no incentive to change their information acquisition strategies. The efficient market hypothesis makes two distinct claims: that all relevant information will be available to the market, and that the market rapidly digests all such information as soon as it becomes available.

Id.

3 Husisian, *supra* note 1, at 415 (citing Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673 (1984)).

teristics associated with public goods, namely, that access by others to the research, once conducted, is difficult to exclude.[4] Investors can benefit from the securities research conducted by others, but this creates a substantial collective action problem.[5] If left to conduct securities research on their own, however, investors would have little incentive to undertake the costly process and thus would not produce sufficient information.[6] What research would be conducted would be costly to the individual and the research would also be costly to society because it would most likely be duplicative.[7] Rating agencies help solve this problem by processing the flow of information and distilling it into a rating useful to the investor at much lower cost than could potentially be incurred by individual investors.[8] In a world without rating agencies, investors' costs at the margin in conducting research would outweigh the benefits and issuers might have to pay higher interest rates to signal their ability in the market and thus encourage investors to invest in their securities.[9] The production of securities information with rating agencies increases the efficiency of the capital markets because rating agencies have expertise, economics of scale, and can communi-

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[4] *See, e.g.*, Husisian, *supra* note 1, at 416; Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 681 (1984); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 724 (1984). The article provides as follows:

> [T]he professional securities analyst typically can do [the research] . . . at a lower cost [than individuals] because there appear to be significant economics of scale and specialization associated with these tasks. As a result, most accounts explaining the stock market's efficiency assign a substantial responsibility to the competition among analysis for securities information. In principle, the information volume by securities analysis by the usual market forces and should result in the usual equilibrium: analysis should invest in verifying and obtaining material information about corporate securities until the marginal cost of this information to them equals their marginal return. Ordinarily, this private equilibrium should also result in allocative efficiency: social resources would be devoted to information verification until the social costs rose to meet the social benefits. There is a basic flaw, however, in this simple neoclassical analysis, and it involves a recurring problem that arises whenever a public good is produced.

Id.

[5] Husisian, *supra* note 1, at 415 (citing John C. Coffee, Jr., *Market Failure & the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 722-33 (1984)).

[6] *Id.* at 415-16.

[7] *Id.* at 419-20.

[8] *Id.* at 416.

[9] *Id.* at 417.

cate distilled information quickly and effectively in the capital markets.[10]

Rating agencies have had sufficient time to develop and refine the rating process as an evaluation of credit risk as they have been assessing utility bonds and corporate bonds since the turn of the century.[11] Likewise, investors have come to rely on bond ratings as a proxy for the probability of default or other interruption in the payment stream.[12] Although in facing competition from other rating agencies and security analysts, a rating agency has strong market incentives to assign credible ratings in order to maintain its reputation.[13] Agencies publish ratings that are correct in an effort to maintain a balance between competition and reputation. This paper will review empirical studies that show that strong market forces compel rating agencies to publish reliable bond ratings and that the rating agencies are successful in assessing relative bond risks.

As methodologies and rating scales change to keep pace with the introduction of new investment products, however, a problem may occur in that the investor may be relying on a rating as a predictor of return or a gauge of *market risk*, instead of as a measure of credit risk only. While such *investor* confusion itself is not enough to warrant regulation of rating agencies, evidence that the *market* suffers similar confusion might justify such intervention.[14] Empirical data correlating ratings for newer products with historical default rates (or other data tending to show the correctness of ratings) has yet to be collected. In the meantime, rating agencies have recognized investor confusion as a problem and have been developing or implementing methodology designed to signal or

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10 Husisian, *supra* note 1, at 421; *see* Coffee, *supra* note 4 and accompanying text.

11 *See* S & P's CORPORATE FINANCE CRITERIA 9, 3 (Frank Rizzo et. al. eds., 1991) ("The rating performs the isolated function of credit risk evaluation, which is one element of the entire investment decision-making process."); *see also infra* note 30 and accompanying text.

12 *See infra* note 25 and accompanying text.

13 *See* Richard Cantor & Frank Packer, *The Credit Rating Industry*, 19 FRBNY Q. REV. 1, 4 (1994). First issues would "no longer believe that they could lower their funding costs by obtaining its ratings." *Id.* Aside from considering damage to its reputation, a rater will also consider legal liability. Husisian, *supra* note 1, at 426. "The very value of an agency's ratings, like an accountant's opinions, lies in their independent, reliable evaluation of a company's financial data." *Id.*; *see also infra* note 125 and accompanying text.

14 *See* Easterbrook & Fischel, *supra* note 4, at 694.

quantify those risks to which the newer products are sensitive.[15] This paper explores whether investor confusion as to the rating scales and as to the meaning of a rating creates inefficiencies in the capital markets that regulation could resolve.

Although there have been recent changes in rated products and rating scales, the rating agencies, themselves, have been deferred to by regulators in numerous regulatory schemes.[16] Federal regulatory reliance on rating agencies prevents intrusion of the government into the field of securities analysis and conserves resources of federal regulators who are not as well-equipped to analyze securities issuances. A regulatory system that relies on ratings can become fine-tuned, less costly for society, as well as simpler to apply for issuers. Usually only rating agencies designated as nationally recognized statistical rating organizations ("NRSROs") by the Securities and Exchange Commission ("SEC"), however, are qualified to issue ratings relied upon by federal regulatory schemes.[17] As federal regulatory reliance on NRSROs increase, questions have been raised concerning the ability of the NRSROs to replace those parts of regulatory oversight.[18] Federal regulation that relies on rating agencies to make determination of credit risk and relative

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15 *See infra* note 48 and accompanying text.

16 *See infra* note 230 and accompanying text. This is not a phenomenon unique to the United States regulatory system; in fact, Portugal is planning legislation which would allow only private companies with credit ratings and certificates of financial soundness from local rating agencies to issue 24 month commercial paper. *See Portugal Plans Own Version of CP Markets; Foreigners to Be Excluded Initially*, THOMSON'S INT'L. BANKING REG., vol. 2. No. 10 (March 16, 1992).

17 *See infra* note 231 and accompanying text (reliance on term 'NRSRO' by legislation and regulation such as Regulation T by Reserve Board). While most regulators use the term "nationally recognized statistical rating organization," some have referred to NRSROs as "SEC recognized rating agencies." For example, National Credit Union Administration employs the term "SEC recognized rating agency" to limit certain investments and to assign risk weights. 12 C.F.R. § 704.2 (1992); 12 C.F.R. § 704 App. A (1992). Other regulators simply rely on rating agencies; for example, the Federal Reserve relies on "bank rating agencies" in Regulation F., allowing banks to rely on bank rating agencies to assess the financial condition of or to select a correspondent if the bank's board of directors has reviewed the assessment and selection criteria used by the rating agency. *See* 12 C.F.R. §§ 206.3, 206.5 (1992). Regulation F also permits banks to rely on information provided to them by rating agencies as true. *Id.*

18 *See, e.g.*, Letter from Representative John D. Dingell to SEC Chairman Richard C. Breeden (July 9, 1992); Letter from John D. Dingell to SEC Chairman Richard C. Breeden (Apr. 28, 1992). *See, e.g.*, Nationally Recognized Statistical Rating Organizations, Securities Act Release No. 7085, 59 Fed. Reg. 46,314 (Aug. 31, 1994) and Comment File S7-23-94 [hereinafter NRSRO Release].

risks work reasonably well and save regulatory costs by avoiding duplicative research and by deferring to the agencies' expertise. Relying on rating agencies is not prudent, however, in certain regulatory schemes which demand accurate evaluation of *absolute* risks, market risks, or other factors not contemplated or performed accurately by a rating agency review.

A further question is raised by the designation process of NRSROs.[19] Over the past decade, the SEC made a discretionary inquiry about whether the designation process itself creates a more specialized NRSRO industry within the rating agency industry generally. Ratings affect the cost of an issuer's capital;[20] more important and more recently, profitable and efficient issuances of some highly structured securities depend on high ratings by *only* NRSROs.[21] Federal regulation calling for ratings by only one NRSRO increases the competition among the few NRSROs capable of rating the security for the issuers' business and may lead to rating shopping. Nondesignated rating agencies are effectively excluded from certain rating markets, and even in unrestricted markets can find themselves at a competitive disadvantage as investors at the margin rely on ratings from agencies designated by the SEC instead of the market performance of the rating agency.[22] Moreover, the designation process, as conducted through no-action letters,[23]

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19 *See* NRSRO Release, 59 Fed. Reg. 46,314 (Aug. 31, 1994). Because of the increased importance of NRSROs, the Commission requests that comments be solicited on the role ratings play in federal securities laws. *Id.* These comments would assist the commission in "establish[ing] formal procedures for designating and monitoring the activity of the NRSRO's." *Id.*

20 *See* Thomas M. Tole and Sammy O. McCord, A *Bond Rating Agency's Influence on Utilities' Cost of Capital*, 117 PUB. UTIL. FORT. 34, 35 (Jan., 1986) (The rating assigned to bonds can influence the cost of capital because if, for example, a rating agency lowers ratings, "investors typically adjust their required returns upward on both debt and equity investments, leading to higher cost of capital."); *but see* Douglas Randall, *A Bond Rating Agency's Lack of Influence on Utilities' Cost of Capital*, 117 PUB. UTIL. FORT. 52 (Feb., 1986).

21 *See infra* note 291 and accompanying text.

22 *See, e.g.*, Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission from Nippon Investors Service, Inc. (Dec. 1, 1994) (Comment File S7-23-94) (noting that "non-U.S. agencies whose expertise may be far greater than NRSROs in the markets in which they operate" are precluded from becoming NRSROs); Letter from Moody's Investor Service to Jonathan G. Katz, Secretary, Securities and Exchange Commission from Moody's (Dec. 5, 1994) (Comment File S7-24-94) (suggesting that designation confers a competitive advantage upon NRSROs) [hereinafter Moody's Comment Letter].

23 *See* NRSRO Release, *supra* note 18.

lacks transparency and accountability, subjecting the SEC to criticisms especially from foreign rating agencies that the SEC's designation protects the U.S. rating industry from foreign competition.[24] Although the SEC releases a list of the criteria it employs in determining which rating agencies should be designated NRSROs, the terms are vague, and the one most significant criterion — that the rating agency demonstrate its "national recognition" in the United States — has been omitted entirely. Formalizing the process into an objective inquiry of publicized and well-defined factors would eliminate some of the appearance that designation is a protectionist measure.

Part I of this paper chronicles the development of the rating industry and describe the rating process and rating scales in order to understand the scope of the ratings and to determine the extent of investor confusion. Part I concludes with a review of the empirical data available purporting to measure the credibility of ratings. These studies conclude that for bonds, and to a certain extent commercial paper, ratings correspond to historical default rates, showing that ratings assess relative risks correctly. These studies, however, do not indicate that ratings reflect absolute risk, as seen in ratings shift over time. While historically ratings represent only credit risk evaluations, new rating scale variations suggest that rating agencies are attempting to expand their traditional analysis to include assessments of market risk.

Part II analyzes the current SEC-administered process of designating certain rating agencies NRSROs for the purpose of federal regulation. Part III catalogs the federal regulatory structures that rely on determinations by NRSROs and analyzes whether the tasks shifted to NRSROs can be performed adequately by them. Part IV discusses regulatory proposals for regulation of the NRSROs. This paper concludes with its own proposal, aimed at resolving the present problems facing the rating industry and federal reliance on ratings.

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[24] *See* NRSRO Release, *supra* note 18 (providing the SEC's description of its criteria in designating an agency an NRSRO).

Part I: The Rating Industry

A. *The Growth of the Ratings Industry*

Mercantile credit agencies, the precursors of modern day rating agencies, were first established in 1837 by Louis Tappan in New York.[25] In 1859 Robert Dun acquired that agency and began publishing ratings guides.[26] Establishing his own mercantile credit agency in 1849, his competitor, John Bradstreet, began publishing ratings books in 1857.[27] In 1933 the two agencies were consolidated into Dun and Bradstreet, eventually becoming the owner of Moody's Investors Service ("Moody's") in 1962.[28]

The ratings business expanded from mercantile credit agencies into securities ratings firms in 1909 when John Moody started up rate U.S. railroad bonds.[29] Other firms shortly followed: Poor's Publishing Company issued its first ratings in 1916, Standard Statistics Company began in 1922, and Fitch Publishing Company in 1924. In 1941, the number of bond rating agencies decreased when Standard Statistics and Poor's Publishing Company merged into Standard and Poor's ("S & P's").[30] Meanwhile, Duff & Phelps had been restricting its business to rating public utility bonds until 1982 when it began to offer wider ranging rating services.[31] McCar-

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25 *See* Cantor and Packer, *supra* note 13, at 1. At least one commentator suggests that in England debt rating was influenced by ship classification companies such as Lloyd's Register of Shipping which in 1760 evaluated the seaworthiness of ships with letters and symbols. Carsten Thomas Ebenroth and Thomas J. Dillon, Jr., *The International Rating Game: An Analysis of the Liability of Rating Agencies in Europe, England, and the United States*, 24 L. & POL'Y INT'L BUS. 783, 794 (1993).

26 Cantor and Packer, *supra* note 13, at 1.

27 *Id.* at 1-2.

28 *Id.*

29 *Id.* at 2. Moody's Investors Services was founded in 1900 when John Moody, a statistician, left Spencer Trask & Company to publish a complete manual of information and statistics of industrial corporations. Moody's Comment Letter, *supra* note 22, at 2. Moody's currently publishes ratings of securities of 4,000 corporations and in 1993, 13,000 municipals. *Id.*

30 Cantor and Packer, *supra* note 13, at 2. S & P's traces its history to 1860. Currently, it rates over $2 trillion worth of debt or other fixed income in more than fifty countries. S & P's *Comments on Proposed NRSRO Regulation*, CREDITWEEK (S & P's Corp.) Dec. 12, 1994.

31 Cantor and Packer, *supra* note 13, at 2. Today, Duff & Phelps rates over 700 corporations including almost all utilities and major issuers of debt, 500 structured financings, 220 commercial paper issuers and 100 insurance companies. Letter of Inquiry to Michael Macchiaroli, SEC Commission from Laura B. Badian, of Lord Bissel & Brook, 1 (Feb. 24, 1981).

thy, Crisanti, and Maffei had a shorter lifespan—founded in 1975, acquired by Xerox Financial Services, and merged into Duff & Phelps in 1991.[32] Currently, there are only four major, full-service United States rating agencies — Moody's, S & Fitch, and Duff & Phelps — each of which is either independently owned or owned by nonfinancial companies to prevent possible conflicts of interest posed by rating securities issued by an affiliate.[33]

The rating agency industry is not characterized by anticompetitive or oligopolistic behavior. These four agencies face additional competition from specialized agencies such as A.M. Best and Weiss Research on insurance company claims-paying abilities, and Thomson BankWatch and IBCA on financial institutions ratings.[34] Furthermore, financial and securities analysts employed by institutions, as well as investment advisers, also conduct market and company specific research in order to make recommendations concerning securities to customers. Rating agencies also increasingly face international competition from foreign rating agencies that rate securities originating in those countries — although foreign countries sometimes locate rating agency services within division of banks or other financial corporations.[35]

Ratings play a critical role in an average investor's investment decision, despite rating agencies' warnings to the contrary. The SEC's policy on disclosure of ratings in 1981 explicitly recognized

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32 Cantor and Packer, *supra* note 13, at 2.

33 Cantor and Packer, *supra* note 13, at 2 (The independently owned rating agencies include: Fitch, Canadian Bond Rating Service, Dominion Bond Rating Service, IBCA Ltd. The rating agencies that are presently owned by nonfinancial companies include: Moody's (Dun and Bradstreet), S & P's (McGraw-Hill), Thomson BankWatch (Thomson Company), Japanese Bond Rating Institute (Japanese Economic Journal), Duff & Phelps Corp.). Those that are owned by financial institutions include: Japanese Credit Rating Agency and Nippon Investor Service, Inc. Ownership by a financial institution creates conflict of interest problems as the rating agency may rate securities issued by a related corporation. *Id.* at 2-3, and table 1.

34 *Id.* at 2.

35 *See* Ebenroth and Dillon, *The International Rating Game: An Analysis of the Liability of Rating Agencies in Europe, England, and the United States*, 24 L. & POL'Y INT'L BUS. 783 n. 1, (1993). There are approximately 36 rating agencies worldwide from the following countries: Australia, Canada, Chile, Cyprus, England, France, Germany, Hong Kong, India, South Korea, the Philippines, Portugal, and the United States. *Id.* Moreover, the *Financial Times* in its publication *Credit Ratings International* lists IBCA, Canadian Bond Rating Service, Japanese Bond Rating Institute, Dominion Bond Rating Service, Japanese Credit Rating Agency, and Nippon Investor Service Inc. as among the most influential bond rating agencies worldwide. *See* Cantor and Packer, *supra* note 13, at 2.

the importance of ratings to investors and to the marketplace.[36] The importance of rating is seen in the federal regulation encouraging the use of securities ratings in administering federal financial projects as appropriate market behavior.[37] Also, in courts, ratings are looked to as an indication of market understanding of the credit risk associated with bonds.[38]

B. *The Rating Scales*

From U.S. railroad bonds, the rating agencies have greatly expanded the scope of their coverage to include many kinds of debt instruments, including municipal bonds, asset-backed securities, medium-term note programs, preferred stock, shelf registration, commercial paper, private placements, and bank certificates of deposit."[39] Rating agencies have also expanded beyond debt rating to other products such as derivatives, the ability of insurance companies to pay claims, risk of mortgage services, the volatility of the price of mutual funds, mortgage-backed securities, and even political stability of sovereign nations.

The rating assigned by the agency is an indication of the likelihood of default or delayed payment of the security.[40] The rating scale has been developed by each individual rating agency to show a gradation from a highly speculative to an extremely safe credit

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36 *See* Proposed Rule Making to Implement the Integrated Disclosure System, Securities Act Release No. 6331-6338 [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,016 (Aug. 6 1981) and Disclosure of Security Ratings, Securities Act Release No. 7086, 59 Fed. ¶ Reg. 46,304 (Aug. 31, 1994). The SEC realized the importance of disclosure to investors and reversed its former policy of non-disclosure of ratings in documents such as prospectuses, registration statements, and offering documents. *Id.*

37 Federal regulation encourages the use of ratings in the marketplace; for example, the Department of Commerce authorizes its Financial Advisors to submit the necessary information to obtain a rating from a national bond rating agency as "proper and desirable" when administrating an Economic Development Administration Project. *See* 13 C.F.R. § 305.71(d)(vi)(d) (1973).

38 *See, e.g., In re* Worlds of Wonder Securities Litigation, 814 F. Supp. 850, 864 (1993) (allegations that issuer misled or omitted material information in prospectus will be carefully scrutinized in light of the fact that the company's debentures were given a low rating by major rating agencies and was "widely considered in the market place to be a risky investment."); *see* Haberman v. Washington Public Supply System, 109 Wash. 2d 107, 744 P.2d 1032, 1045 (1987) (ratings as an indication of market acceptance can be challenged if issuer provides false or misleading information).

39 Cantor and Packer, *supra* note 13, at 3.

40 *See* S & P's DEBT RATINGS CRITERIA 40 (Roy Weinberger, ed. 1986) [hereinafter DEBT RATINGS CRITERIA].

risk.[41] Each rating agency employs its own unique scale for long-term debt, with a different scale for commercial paper. Some rating agencies' scales, however, use similar symbols which correspond to different interpretations.[42] A rating agency usually furnishes in its publications textual interpretations of the symbols employed in the scale to assist the investor in understanding the rating system. Although the older rating agencies have utilized the same basic scale for rating bonds for up to 75 years, each has added

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41 The following is a comparison of Moody's and S & P's investment grade bond rating schedules. (Duff & Phelps and Fitch employ a scale similar to S & P's):

Category	S & P's	Moody's	Interpretation
I	AAA	Aaa	Highest quality
II	AA+	Aa1	High quality
	AA	Aa2	
	AA–	Aa3	
III	A+	A1	Strong payment capacity
	A	A2	
	A–	A3	
IV	BBB+	Baa1	Adequate payment capacity
	BBB	Baa2	
	BBB–	Baa3	

A comparison of speculative grade ratings of Moody's and S & P:

Category	S & P's	Moody's	Interpretation
V	BB+	Ba1	Likely to fulfill; ongoing uncertainty
	BB	Ba2	
	BB–	Ba3	
VI	B+	B1	High risk obligations
	B	B2	
	B–	B3	
VII	CCC+		Current vulnerability to default (S &
	CCC	Caa	P's) or in default (Moody's)
	CCC–		
VIII	C	Ca	In bankruptcy, default or marked
	D	D	shortcoming

For S & P's rating definitions *see* S & P's CORPORATE FINANCE CRITERIA 9, 8 (Frank Rizzo et. al. eds., 1991). For Moody's rating definitions *see* Cantor and Packer, *supra* note 13, at 3.

42 S & P's CORPORATE FINANCE CRITERIA 9, 7 (Frank Rizzo et. al. eds., 1991) (S & P's commercial paper scale employs the symbols: "A-1," "A-2," "A-3," "B," "C," "D" with additive pluses and minuses). Moody's bond rating scale uses A1 to indicate the third category; however, A-1 is the top category for S & P's commercial paper. *See id.* Moreover, while Duff & Phelps employs a bond rating scale similar to S & P's, their commercial paper scale ranges from "D-1" to "D-5" with pluses and minuses in the first category. Ederington and Yawitz, *The Bond Rating Process,* HANDBOOK OF FINANCIAL MARKETS, Ch. 23 (Edward Altman, ed. 1987), at 23. That is, a "D-1" from Duff & Phelps means very secure repayment capability of commercial paper but a "D" from S & P's indicates probable default prior to maturity of commercial paper. *Id.*

variations and distinctions within categories either to offer the investor more precise ratings, to account for new products, or to recalibrate the scale to compensate for ratings shift.[43] Differentiations within a category were created as recently as 1973 for Fitch, 1974 for S & P's, and 1982 for Moody's.[44]

The rating scales were developed for traditional fixed-term obligations, such as corporate debt and preferred stock, which pay fixed sums in the form of interest and principal or dividends at regular intervals. Rating agencies have also expanded the scope of their coverage as new products have been offered in marketplace.[45] These products, such as mortgage-backed and asset-backed securities and other highly structured or derivative financial instruments, offer a return based on, or are sensitive to, the value of the assets underlying the securities, indices, interest rates, or cash flows. Because of these non-credit payment risks, there is substantially more risk to yield a higher return compared to traditional debt obligations of comparable credit rating.

In response to the development of these contingent products, rating agencies have introduced new methodologies and rating scale variations.[46] Most of these rating innovations are intended to

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43 S & P's ratings can be further modified by the addition of a "c" (indicating that the holder's option to tender the security for purchase may be canceled under prestated conditions), a "L" (indicating that the rating pertains to the principal amount of those bonds to the extent that the underlying deposit collateral is federally insured and interest adequately capitalized), a "P" indicating a provisional rating), an "outlook" such as negative, positive, stable or developing to indicate expected future changes in the rating, and an "R." *See infra* note 52 and accompanying text (discussing S & P's use of the "R" rating securities). In addition, S & P's will place an issuer on CreditWatch if a particular event such as a merger or acquisition creates potential for a rating change. *Id.* In January, 1994, S & P's has also introduced a new rating system for mutual bond funds. *See Bond Fund Risk Ratings for* 1994, CREDITWEEK (S & P's Corp.), Jan. 23, 1995.

44 *See* HUGH SHERWOOD, HOW CORPORATE AND MUNICIPAL DEBT IS RATED: AN INSIDE LOOK AT STANDARD & POOR'S RATING SYSTEM 12, 1976. In 1974, S & P's added pluses and minuses to categories two through fire. In addition, industry groups within the rating agencies announce newer methodology frequently. *See, e.g.*, W. Lynn Garner, *Moody's and Fitch Revise Credit Rating Criteria*, PUB. UTIL. FORT. (July 15, 1994) (detailing Fitch's move toward including nonfinancial information in utilities ratings and Moody's new methodology in identifying low-cost producers in the utilities industry).

45 Cantor and Packer, *supra* note 13, at 3.

46 *See, e.g.*, Fitch Investors Services, *CMO Volatility Ratings Measure Risk* (Special Report) (Nov. 10, 1994); *see also "r" Added to Volatile Derivative/Hybrid Ratings*, CREDITWEEK (Standard & Poor's Corp.) July 11, 1994.

signal that a security is highly sensitive to market risks that may or may not have been previously analyzed by the rating agency.[47]

For example, Fitch has developed a volatility rating ("V-rating") which assesses the potential impact of interest rate movements and other market risks on individual tranches of issuances.[48] The V-rating developed as a response to the failure of disclosure requirements to keep investors adequately informed of the risks involved in the newer securities products.[49] They signal to the investor that the security is sensitive to other risks besides credit risks and quantify that risk on a linear scale from V-1 (subject to low market risk) to V-10 (signifying speculative market risk).[50] In assessing market risk for a bond fund, for example, Fitch will go beyond credit risk, and also assess interest rate risk (including reinvestment risk from prepayments and contingent cash flows), currency exposure, liquidity, leverage ratios, the issuer's policy toward holding derivatives, diversification, and the experience of management.[51] Since a bond fund will receive two ratings — one for credit risk and the other for market risk — more analysis and disclosure of bond fund risks will be available for investors.

S & P's, likewise, has introduced an "r" symbol that it attaches to its regular rating symbols to indicate that the security, usually a derivative, may be volatile or fluctuate because of increased market risks.[52] Serving as a warning to investors, the "r" addition does not change the underlying rating.[53] S & P's motivation in creating the "r" rating was to emphasize that ratings normally comment only on

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47 *Id.*

48 *See* Fitch Investors Services, *CMO Volatility Ratings Measure Risk* (Special Report) (Nov. 10, 1994). Fitch is considered the most innovative agency in rating asset-backed and mortgage-backed securities. As such, it has been able to increase its market share substantially in the past three years in the asset-backed and mortgage-backed markets. *See generally*, Ron J. Wechsler, *Rating Single-Borrower Commercial Mortgage Transactions*, New Developments in Securitization, PLI Commercial Law and Practice Course Handbook Services (Nov.-Dec., 1994).

49 *See* Fitch Investors Services, *Disclosure and Measurement of Bond Fund Risk* (Special Report) (Dec. 12, 1994).

50 *Id.*

51 *Id.*

52 *See "r" Added to Volatile Derivative/Hybrid Ratings*, CREDITWEEK (Standard & Poor's Corp.), July 11, 1994; "r" *Added to Volatile Derivative/Hybrid Ratings*, Special Report, CREDITWEEK, July 18, 1994; "r" symbols will be attached to ratings of securities whose principal or interest return is indexed to equities commodities or currencies; certain swaps and options; interest only and principal only mortgage securities. *Id.*

53 *Id.*

credit risk and "r" signifies that other risks not evaluated in a rating may affect the return.[54] In adding the "r" symbol, S & P's admitted that "the market has used ratings as a proxy for total return, even though ratings primarily address credit risk."[55] The "r" symbol is intended as a temporary measure while S & P's develops more refined market-risk measures that quantify non-credit risks.[56] Although investors may understand that an "r" attached to a credit rating signifies market volatility, it is not clear that investors will understand that a rating without an "r" is simply a credit risk rating and not a certification that the security is free from risk.[57]

Rating agencies are also utilizing symbols to signal differing methodological analysis.[58] When determining an unsolicited rating for insurance companies, S & P's uses a "q" to indicate the "qualified solvency rating" methodology — a purely statistical rating based solely on public financial data that broadly distinguishes between classes of insurance companies.[59] In the alternative, S & P's will charge insurance companies a fee for rating their claims-paying ability and for evaluating the financial data together with other, more subjective criteria (such as industry risk, quality of management, sources of competitive advantage, operational analysis, financial flexibility). While there seems to be a linkage between the qualified solvency ratings and claims-paying ability ratings, a recent study found that the relationship is weak.[60] More

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54 *Id.*
55 *Id.*
56 *Id.*
57 "r" *Added to Volatile Derivative/Hybrid Ratings*, CREDITWEEK (Standard & Poor's Corp.), July 11, 1994.
58 *See, e.g.*, *Hearing infra* note 60 and accompanying text.
59 *Id.* Based on statistical and comparative analysis of state-mandated financial database of insurance company financial statements, a qualified solvency rating involves a new statistical model for differentiating broadly between classes of risk to policyholders of an insurance company. *Id.* A qualified solvency rating is not as extensive as review as a claims-paying ability rating. *Id.*
60 *See Insurance Rating Companies: Hearing before the Subcomm. on Commerce, Consumer Protection, and Competitiveness of the House Comm. on Energy and Commerce*, 102d Cong., 2d Sess., 7-8 (1992) [hereinafter *Hearing*]. Associate Director of Moody's Investors Services Chester Murray indicated in his statement to the Subcommittee that the insurance industry has fundamentally changed, complicating the rating process. *Id.* at 28-33. He noted eight factors which have led to this change: decreasing public confidence, early policyholder withdrawals, early and preemptive regulatory intervention, the growing irrelevance of conventional liquidity analysis, large real estate holdings by insurance companies, weaker sales of accumulation products, shifting concentration of assets, and accounting paradigm shifts. *Id.*

important, similar systems of symbols are employed in each rating with an unsolicited "q" rating ranging in three categories from "BBBq" (most solid financially) to "BBq" (adequate) to "Bq" (most troubled), whereas a solicited claims paying ability rating ranges throughout the same scale as a corporate bond.[61] The fact that S & P's will publish only one of the ratings intensifies the pressure on insurance companies to seek S & P's solicited ratings for a fee.

At least one rating agency has developed a new methodology to evaluate the likelihood of receipt of a specified amount of cash flow — combined interest and principal payments on the underlying assets — from the pooled securities, without regard to whether such payment amount constitutes interest or principal payments.[62] This rating assesses the likelihood of receiving a specified dollar amount of cash over the life of the security.[63] Unlike traditional ratings, cash flow ratings are limited in scope and do not rate the likelihood of payment in accordance with the product's actual or expected terms. Investors may be misled by limited ratings, not necessarily because they do not understand that the rating assesses to be only a limited aspect of the issuer, but because bond ratings in the past have been highly correlated with yield.

While investor confusion concerning the new rating scale variations and the newly-rated products offered more regularly to the public surely exists, the question becomes whether investor confusion poses a problem able to be solved by regulation. At the margin, unsophisticated investors will rely on favorable or merely favorable sounding ratings. This presents a problem, however, only when the market has not accurately priced the underlying security. The rating industry will experience market failure only if

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61 *Id.* A qualified solvency rating of "BBBq" will most likely correspond to a claims paying ability rating of "AAA," "AA," "A," "BBB," a "Bbq" qualified solvency rating similarly corresponds to a claims paying ability rating of "A," "BBB," "BB," "B," while a "Bq" qualified solvency rating is correlated with a claims paying ability rating range of "BB," "B," "CCC," and "CC," *Id.* S & P's reports that in their short history, qualified solvency ratings have been successful in identifying as vulnerable 19 of 22 S & P's rated life insurance companies that failed in 1991. *See Hearing, supra* note 60, at 45 (testimony of Roy Taub, Executive Managing Director, Insurance Rating Services, S & P's).

62 *See, e.g.*, Duff & Phelps Credit Rating Co., *Rating Prepayment Sensitive Cash Flow Securities*, (Special Report) (Aug. 1993).

63 *Id.*

the market is not impounding ratings accurately — which will result in inaccurate prices and yields of the security.

C. *Organizational Structure and Conflicts of Interest*

Rating agencies have traditionally earned income in two ways — publication of analysis and ratings, thereby charging investors indirectly. Currently only IBCA with 600 institutional subscribers, is driven by publishing revenues.[64] Most of the rating agencies will offer in-depth analysis in the form of weekly or monthly publications directly to investors or to institutional investors.[65] Providing the service directly to the investor, however, encounters copying and billing problems usually associated with public goods individual investors are confronted by a collective action problem; that is, the information and analysis cost more than the benefit that accrues to a single investor. The collective action problem creates an incentive for investors to duplicate the information. These problems increased both as the rating process became more complicated and costly, and as copying and disseminating materials became easier and less costly.

Most rating agencies presently charge the issuer a fee for the rating service.[66] This market practice was developed in the 1970s[67] upon the default of Penn Central on $82 million of commercial paper.[68] Previously, commercial paper had usually not been rated as investors assumed that any commercial paper issued by a household name firm carried an acceptable credit risk.[69] When Penn Central defaulted, issuers of commercial paper themselves solicited ratings to lower their capital costs and encourage investment in commercial paper.[70] Fees from issuers now comprise a large percentage of annual revenues of many rating agencies; for example,

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64 *See* IBCA Limited, SEC No-Action Letter, [1990-1991] Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,624, at 77,823 (Nov. 27, 1990), (Oct. 11, 1990).

65 *See, e.g.*, Standard and Poor's CREDITWEEK (Standard and Poor's Corp.); Moody's Investor's Service, Inc.'s MOODY'S BOND RECORD. IBCA is subscriber-driven, although it will rate issuers that request ratings. *See* Cantor and Packer, *supra* note 13, at 5.

66 *See* Cantor and Packer, *supra* note 13, at 4.

67 Cantor and Packer, *supra* note 13, at 4. S & P's charging municipal bond issuers in 1968 and most other issuers in 1971; Fitch and Moody's began charging issuers in 1970.

68 *See id.*

69 *Id.*

70 *Id.*

four-fifths of S & P's revenge is derived from issuer fees.[71] The charges usually vary depending upon the size and complexity of the issue.[72] Currently, a new long-term corporate bond issue ranges from two to three basis points of the principal for each year the rating is maintained.[73] Rating agencies maintain quarterly charges on commercial paper based on amounts outstanding up to seven basis points plus an annual fee.[74] Although making fees contingent on the size and success of the issuance appears to create an incentive for the rating agencies to overrate an issuer to increase its fees, the rating agencies' strong interest in preserving their reputation in order to compete effectively with other rating agencies and providers of securities research largely prevent exploitation of the fee structure.[75]

D. *The Ratings Process*

Rating agencies primarily evaluate credit risks.[76] Credit risks can stem from business risks including industry characteristics, introduction of technology, marketing strategies, and management's track record, or financial risks including financial policy of management, profitability, capital structure, and cash flow protection.[77] Therefore, ratings take into account evaluations of the industry as a whole, regulatory trends, and the issuer's business fundamentals.[78] The rating process usually begins with a request by the is-

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71 *Id.*

72 *See* Cantor and Packer, *supra* note 13, at 4. Canadian Bond Rating Service bills hours spent on the analysis and complexity rather than a percent of the issue. *See* Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission from Brian I. Nevsmith, Canadian Bond Rating Service, (Nov. 10, 1994) (Comment File No. S7-23-94) [hereinafter CBRS Comment Letter].

73 *See id.*

74 Cantor and Packer, *supra* note 13, at 4.

75 *Id.*

76 *See* Douglas Randall. *A Bond Rating Agency's Lack of Influence on Utilities Cost of Capital*, 117 PUB. UTIL. FORT. 52 (Feb 20, 1986).

77 *See* DEBT RATINGS CRITERIA, *supra* note 40, at 21. There has been a "shift in S & P's analytical focus away from historical financial statistics toward business analysis." *Id.* at 17.

78 *Cf.* Coffee, *supra* note 4, at 723-24. ("The work of the securities analyst can be subdivided into two basic functions. First, the analyst searches for information obtainable from non-issuer sources bearing on the value of a corporate security. Often this information is critical because the issuer's performance may be substantially dependent on exogenous factors- *e.g.*, interest rates, the behavior of competitors, governmental actions, consumer attitudes, and demographic trends—about which the issuer

suer or the issuer's underwriter about a month ahead of issuance.[79] After assigning a lead analyst, a backup analyst and support personnel, the rating agency performs a preliminary analysis of the issuer's public financial information, including a registration statement, a prospectus, the most recent annual or quarterly report, annual reports from the past five years, and subsequent quarterly financial statements.[80] The analysts also receive information directly from the issuer, which may include nonpublic information, such as forecasts of key elements like future earnings, the company's capital spending plans, and future financing plans.[81] In addition, S & P's asks for management's comparisons with its competitors.[82] Although certain information is required for the agencies to rate the security, issuers themselves offer additional beneficial information to receive a higher rating.[83]

Based on the information collected, the rating agency first ensures that the financials conform with generally accepted accounting principles ("GAAP").[84] Although a rating review is not an audit, the rating agencies calibrate financials of a company to compare it effectively with its industry competitors.[85] The financial information is distilled into a variety of ratios such as pretax interest coverage, funds from operations as compared with long-term debt, pretax return on permanent capital, operating income as compared with sales, long-term debt as compared with capitalization,

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has no special knowledge or the analyst has superior access. Second, the analyst verifies, tests, and compares the issuer's disclosures, both to prevent deliberate fraud and to remove the unconscious bias that usually affects all forms of information transfer.").

79 *See* Ederington & Yawitz, *supra* note 42, at 22; SHERWOOD, *supra* note 44, at 138. For mortgage-backed securities, the process takes between 6 to 8 weeks depending on the number of properties the rating agency has to visit. *See also* Ron J. Wechsler, *Rating Single-Borrower Commercial Mortgage Transactions*, New Developments in Securitization, PLI Commercial Law and Practice Course Handbook Services (Nov.-Dec., 1994).

80 *See* SHERWOOD, *supra* note 44, at 27-28. Thomson BankWatch Inc., SEC No-Action Letter,[1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,800, at 78,597 (Aug. 6, 1991) [hereinafter Thomson BankWatch No-Action Letter].

81 Such predictive material is gathered largely as a method for evaluating whether management has a long-term outlook, is setting realistic goals, has backup and flexibility, and is credible. *See* DEBT RATINGS CRITERIA, *supra* note 40, 13.

82 *See* DEBT RATINGS CRITERIA, *supra* note 40, at 13; Ederington & Yawitz, *supra* note 42, at 24.

83 *See* SHERWOOD, *supra* note 44, at 138.

84 *See* Moody's Comment Letter, *supra* note 22, at 8.

85 DEBT RATINGS CRITERIA, *supra* note 40, at 24.

and total debt as compared with capitalization including short-term debt.[86] These "key ratios" correspond to rating categories, for example, "AAA" rated long-term debt had a medium pretax interest coverage into 10.46 for 1983-1985, "AA" had 8.21, "A" 5.53, and so on.[87]

Financial analysis, however, is only one component of a rating.[88] Subjective in nature, business analysis has become the mainstay of rating agencies.[89] In the preliminary analysis, the analysts determine the overall state of the industry and the "keys to success" of the industry, whether price, quality, image, product differentiation, service, or some other factors.[90] To prove its credibility and to detail goal setting and future planning, management usually provides the rating agencies with copies of internal memoranda of the board of directors.[91] This nonpublic information received directly from the issuer is held in strict confidence by firewalls separating departments within the rating agency.[92] Organized into industry specialties, however, the rating agency obtains efficiencies by assigning the same analytic team to competitors.[93] Although possibilities for illegally handling nonpublic information exist, disclosure to the rating agencies may be an effective conduit through which management can signal the results of viewing confidential information to the market without incurring the costs of full disclosure.[94]

Although the rating agencies do not explicitly encourage com-

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86 *Id.*

87 *See* DEBT RATINGS CRITERIA, *supra* note 40, at 51. Each ratio corresponded progressively from gradation to gradation. *See* SHERWOOD *supra* note 44, at 14, 30-31.

88 Wechsler, *supra* note 48, at 28. Rating analysis conforms to the particularities of the product rated. *Id.* at 29. For example, mortgage-backed securities ratings are cashflow driven, making the rating more highly dependent on financial analysis. *Id.* at 33-37. Fitch, the leading rating agency in the structured finance field, requires issuers to provide information for cashflow analysis, adjustments to net operating income, reserves for replacement, additional reserves, interest rates, loan to value, overleverage and subordinate debt, and, to a lesser extent, a variety of qualitative analyses. *See id* at 28-32.

89 *See* DEBT RATINGS CRITERIA, *supra* note 40, at 23.

90 *See id.* Analysts do not consider size, differentiation or name recognition as determinative of ratings; although loosely correlated to ability to meet obligations, these factors are not indicative of future success and are not substituted for analysis. *Id.*

91 *See* SHERWOOD, *supra* note 44, at 35-36.

92 DEBT RATINGS CRITERIA, *supra* note 40, at 13.

93 *Id.*

94 *See* Ederington & Yawitz, *supra* note 42, at 24.

panies to conduct themselves with an eye toward a specific rating, companies set certain ratings as objectives and structure deals around the ratings criteria, even though pursuing low risk strategies may not be the best course for a company because the company may forgo opportunities for growth.[95] More frequently, companies seek organizational compromises to assure high ratings; rating agencies, however, do not always oblige. For example, a captive finance company, or a subsidiary finance company with over 70% of its portfolio consisting of receivables generated by the parent's business will be considered merely a division of the parent and receive the same rating as the parent.[96] As a general matter, parent companies and affiliates of an issuer will undergo the same rating process as the issuer.[97] Such treatment prevents competitors from obtaining a rating advantage through company restructuring.

Structuring issuances, on the other hand, can result in rating differences.[98] The nature and provisions of supporting legal documents, for example, can enhance a rating.[99] Usually a rating is not concerned with rights upon default, but when holders of secured debt would fare significantly better than holders of unsecured debt, the rating agency signals the collateralization for secured debt by placing unsecured debt one notch below within investment grade and two notches below in speculative grade.[100] Likewise, in the structured finance market issuers typically request a rating level along with financial information or property descriptions to elicit assistance from the rating agencies in structuring the security.[101]

Throughout the rating process, the issuer's management plays a significant role.[102] As instigator of the process and provider of

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95 *See* DEBT RATINGS CRITERIA, *supra* note 40, at 3 ("The more appropriate approach is to operate for the good of the business as management sees it and to let the rating follow.").

96 *Id.* at 32.

97 *See generally* DEBT RATINGS CRITERIA, *supra* note 40, at 37-42.

98 This is especially true for highly structured instruments. *See infra* note 291 and accompanying text. *See also, In re* Westinghouse Securities Litigation, 832 F. Supp. 948, 958 (1993) (noting that a parent maintains its subsidiary's rating by propping up debt to equity ratios).

99 SHERWOOD, *supra* note 44 at 28.

100 *See* SHERWOOD, *supra* note 44, at 31. A notch is the difference between a rating and the next closest rating, *e.g.*, the difference between "AAA" and "AA+" represents

101 *See* Wechsler, *supra* note 48, at 28-33.

102 *See* SHERWOOD, *supra* note 44, at 139. Sherwood notes that one way a corporation can improve its chances of getting a high rating is to send a number of high level

financials, management is itself evaluated during the rating's analysis. Both S & P's and Moody's allow representatives of the issuer's management (namely, chief executive officers, chief financial officers, and treasurers) to attend rating meetings.[103] Issuers subsequently meet with S & P's once a year while the debt is outstanding to present nonpublic information and plans for the future.[104] During the rating process, issuers are in constant contact with the rating agencies, seeking the rating agency's feedback in order to offer more information or support for its policies in an attempt to obtain a higher rating.[105]

Although the rating process is a standardized procedure which arrives at a rating recommendation, rating agencies emphasize that the process is not formulaic.[106] Typically, rating agencies make normative judgments about the quality of management, the potential for regulatory interference or market downturns, and the development of the industry as a whole.[107] Most rating agencies rely on their analysts' judgment both in evaluating the management of the issuer and in adjusting the overall rating after the quantitative analysis is complete.[108]

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management to the issuer meeting each of whom is capable of answering questions about finances, operations and philosophy. *Id.*

[103] *See also* SHERWOOD, *supra* note 44, at 22. In addition, Thomson BankWatch meets with senior management of the issuers it rates at least twice annually, but generally quarterly. *See* Thomson BankWatch No-Action Letter, *supra* note 80, at 78-597.

[104] *See* S & P's CORPORATE FINANCE CRITERIA 9 (Frank Rizzo et. eds., 1991).

[105] *Id.* at 3. Issuers typically seek an agency's "guidance on credit quality issues that might affect [the rating agency's] opinion of corporate creditworthiness."

[106] *See, e.g., Hearing, supra* note 60, at 42 (testimony of Executive Managing Director Roy Taub of S & P's) ("[W]hile a considerable amount of financial and business data is considered in arriving at a claims-paying ability rating decision, those ratings are not determined via a 'calculation.'"); Moody's Comment Letter, *supra* note 22, at 6 ("Ratings are expressions of opinion about risk, not statements of, or even predictions about, facts. There is not now, nor can there ever be, a science or an orthodoxy for debt ratings.").

[107] *Id.* at 48-50.

[108] *See* General Accounting Office, *Insurance Ratings: A Comparison of Private Agency Ratings for Life/Health Insurers, Briefing Report to the Chairwoman of the Subcomm. on Commerce, Consumer Protection, and Competitiveness, House Comm. on Energy and Commerce,* at 7 [hereinafter GAO Study]. Only Weiss Research did not rely on its analysts to ratchet the rating upwards or downwards. Instead, Weiss includes an evaluation of management in its mathematical model. *See also,* DEBT RATINGS CRITERIA, *supra* note 40, at iii (preface) ("In determining a rating, both quantitative and qualitative analyses are employed. The judgment is qualitative in nature and the role of the quantitative analysis is to help the best overall qualitative judgement, because, ultimately, a rating is an opinion.").

After the preliminary analysis and the meeting with the issuer, the senior analysts prepare a final rating profile which is presented to the rating or credit committee.[109] The rating committee discusses and votes on the appropriate rating.[110] Performing an oversight role, the rating committee ensures that ratings are consistently and evenhandedly assigned from industry to industry.[111] At this point, proposed ratings can be raised or lowered depending on how the presentation is perceived by the ratings committee.[112]

After the vote, depending on the rating agency, the issuer may be notified of the rating decision as a last check to ensure that the information upon which the rating is based is complete and accurate.[113] Prior to publication, issuers are required to keep the rating confidential.[114] Other rating agencies, such as IBCA, instead submit factual reports to issuers upon which the rating is based to correct any errors, but do not issue the rating itself before publication.[115] During the period prior to publication, some rating agencies permit the issuer to appeal the rating decision by supplementing or correcting the information upon which the rating is based.[116] An appeal process safeguards against the release of inaccurate ratings as well as maintains close contact with the issuer to explain the rating.

At this point, an issuer may be able to withdraw the request for a rating, thereby suppressing publication of the rating.[117] How-

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109 *See* SHERWOOD, *supra* note 44, at 22. Rating committees consist of the analytic team plus other members of the corporate finance department and the vote is by a majority. *Id.*

110 *Id.*

111 *Id.*

112 *Id.*

113 Thomson BankWatch, *supra* note 80, at 78,597 (Thomson BankWatch and S & P's both notify the issuer prior to publication).

114 *See, e.g.* Thomson BankWatch, *supra* note 80, at 78,597.

115 *See* IBCA Limited, SEC No-Action Letter, [1990-1991] Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,624, at 77,823 (Nov. 27, 1990), (Oct. 11, 1990).

116 S & P's CORPORATE FINANCE CRITERIA 9, 10 (Frank Rizzo et. al. eds., 1991). *See* DEBT RATINGS CRITERIA, *supra* note 40, at 9, 10; *see also,* Thomson BankWatch No-Action Letter, *supra* note 80, at 78,597; SHERWOOD, *supra* note 44, at 22. Sherwood reports that, as of 1976, about one fifth of appeals are sustained with the bonds issued raised to the next category of rating. *Id.*

117 CORPORATE FINANCE CRITERIA, *supra* note 11, at 5. S & P's rates practically all corporate debt and preferred stock over $25 million if long history unsolicited, without an issuer's right to suppress. *Id.* S & P's rates private placements and mortgage-

ever, at some rating agencies, such as Thomson BankWatch, issuers are not able to suppress an unfavorable rating.[118] Once a rating has been published, it will not be withdrawn unless the rating agency no longer has access to full information upon which to base a rating.[119] To suppress unfavorable ratings at those rating agencies that do not allow issuers to withdraw requests for ratings, an issuer can simply request a preliminary rating from the analysts before submission to the ratings committee to assist it in making a decision on whether to issue the bonds at all.[120]

After this intensive process, most rating agencies assert that the rating remains current for about two years or until withdrawn or changed, since short-term performance is not likely to diverge from expectations.[121] Most rating agencies keep active surveillance over the issuers they regularly rate. For example, Thomson BankWatch monitors its public companies in a quarterly review and its nonpublic companies usually quarterly but at least biannually.[122] S & P's maintains an annual update schedule for all issuers of long-term debt.[123] In addition, each time an issuer issues new securities, rating agencies will review the previous ratings assigned.[124]

Although a detailed process, rating agencies underscore that ratings are not meant to be the only factor considered in making an investment decision. Neither S & P's nor Moody's undertake investigative work of their own and limit their evaluations to public information and nonpublic information provided by the issuer.[125] S & P's cautions that even a top rating is not a recommendation to

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backed securities only upon request of the issuer with the issuer gaining the ability to publish the rating. *Id.* As for short-term debt, S & P's rates it only upon request with publication of the initial rating only with the issuer's approval. *Id.*

118 *See* Thomson BankWatch No-Action Letter, *supra* note 80, at 78,597.

119 DEBT RATINGS CRITERIA, *supra* note 40, at 9, 10.

120 *See* SHERWOOD, *supra* note 44, at 23.

121 *See* DEBT RATINGS CRITERIA, *supra* note 40, at 11. S & P's withdraws ratings if the issuer pays off its issue, if the issue falls below the required $25 million to maintain a rating, or if there is a lack of sufficient information upon which to base a rating. *Id.*

122 *See* Thomson BankWatch No-Action Letter, *supra* note 80, at 78,597.

123 Sherwood, *supra* note 44, at 22.

124 DEBT RATINGS CRITERIA, *supra* note 40, at 13.

125 *See* DEBT RATINGS CRITERIA, *supra* note 40, at 3 ("The rating does not . . . attest to the authenticity of the information provided by the issuer and upon which the rating may be based.").

purchase, sell or hold a particular security.[126] Moody's specifically warns that "the attractiveness of a given bond may depend on its yield, its maturity date, or other factors for which the investor may search, as well as on its investment quality, the only characteristic to which the rating refers."[127] A rating, therefore, purports to assess the issuer not the debt instrument itself.[128]

E. *Credibility of Ratings*

Despite the fee arrangements and reliance on information directly provided by the issuer, rating agencies are not apt to overrate or underrate issuers due to strong market forces. The rating industry is, for the most part, competitive.[129] Although there are only 4 major rating agencies, specialized rating agencies, financial and securities analysts, and financial newspapers compete to provide investors with information. Even if a rating agency were tempted to overrate or underrate issuers, past ratings performance can be simply monitored and is tracked by many investors over time since ratings are readily visible.[130] If a rating agency underrates an issuer, the issuer's cost of capital increases and the issuer will not bring its rating business back to that rating agency the next time the issuer returns to the capital market. Also, the pressure placed on the rating agency is more intense if the issuer routinely raises money through debt issuance. Whereas competitive forces between the issuer and the rater prevent underrating, investors prevent overrating.[131] If a rating agency were to overrate an issuer, investors would, over time, discount the value of the rating because they would receive too little interest to compensate them for the risk.

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126 *See* DEBT RATINGS CRITERIA, *supra* note 40, at 3.

127 *See* MOODY'S INVESTOR'S SERVICE, INC., MOODY'S ON MUNICIPALS: AN INTRODUCTION TO ISSUING DEBT (Fred S. Ackerman, ed., 1987) at 49.

128 *See* James H. Downs, *Time—The Enemy of a Company's Quality Rating*, TR. & EST., (Aug. 1982) at 23, 24; *but see* Thomson BankWatch No-Action Letter, *supra* note 80, at 78,596-97. Thomson BankWatch assigns both "short-term debt ratings" and "issuer ratings." *Id.* The issuer rating retains currency for two years. *Id.*

129 *But see* Coffee, *supra* note 4, at 745. (indicating that rating agencies are few in number and have conflicts of interest that may prevent them from acting competitively).

130 *See, e.g.*, Janet L. Fix, *FDIC: Moody's Was "Confused" in Downgrading Meritor*, PHIL. INQUIRER, May 6, 1989.

131 Presumably, investors would also over time understand the rating agency's rating to signify more stability, resulting in an upward rating shift. No commentators have notice upward shifts.

Likewise, if a rating agency overrates an issuer, investors will devalue the ratings of the agency generally, causing the interpretations of those ratings to shift.[132] If the investors are very skeptical of the rating agency, issuers will choose not to obtain a rating from that agency. Strong issuers would therefore avoid the rating agency that overrates issuances and, instead, solicit ratings from more conservative rating agencies to signal their stability to potential investors. Because this effect is cumulative, it is possible for a rating agency to overrate or underrate issuers in the short-run before investors and issuers impound the information, but in the long-run the damage to the rating agency's reputation will far outweigh the short-term benefits.

Although rating agencies do not independently verify information supplied to them by issuers, market discipline should likewise prevent abuse. If issuers omit or misrepresent information, a rating agency will presumably charge the issuer more for the rating service in the future to compensate for the extra work and insecurity. More importantly, the issuer would receive lower marks for management credibility which may have a downward effect on ratings for some time to come. In short, an agency's rating is valuable only so long as it is an independent and reliable assessment of the issuer.[133]

The theory that market forces compel reliable ratings is borne out by empirical data. Ederington & Yawitz compared reported data for all firms that defaulted between January 1970 and December 1984 and found that only one of 88 firms that had defaulted was rated investment grade by S & P's (the issuer was rated A or in the third category), and only 16 were rated higher than B ("high

[132] *See*, Victor F. Zonana, *Are the Watchdogs Watching?*, L.A. TIMES, Jul. 18, 1991 at A1 (A.M. Best was most criticized in 1991 insurance failures). A.M. Best is known as the most forgiving of the insurance rating agencies. Jane Bryant Quinn, April column quoted by Chairwoman Collins in *Hearing supra* note 60, at 97. In an attempt to change its reputation, A.M. Best has announced a recalibration of the rating scale which includes more gradations for ratings. *Id.*

[133] *See* DEBT RATINGS CRITERIA, *supra* note 40, at 3 (Ratings are of value only so long as they are credible. Credibility arises primarily from the objectivity which results from the rater being independent of the issuer's business.). This fact is one of which the rating agencies themselves are very much aware. *See also*, Moody's Comment Letter (Comment file No. S7-24-94), *supra* note 22, at 2 ("It was precisely their reputation for independence and integrity that was and is the basis for the respect that the rating agencies have to date enjoyed.").

risk obligations" in the sixth category).[134] The study also found that between 1974 and 1984 the average default rate on nonconvertible debt rated "BB" or lower by S & P's was 1.60% a year as compared to .08% a year for all nonconvertible debt.[135] Thus, ratings are correlated to default rates.

S & P's 1993 update of historical default rates and rating transitions of over 3,500 corporations continues to show that average cumulative default rates from 1981 to 1991 increase as one moves down the rating scale, with the gap as high as 31%.[136] It further shows a wide divergence between investment grade and speculative issues; for example, of 88 bond issuers experiencing defaults or similar situations in 1991, only one was rated investment grade and most had been downgraded in 1990. Rating agencies may not be as good at predicting the one-year default rates of speculative issuers as shown by a mean speculative default rate of 4.9% with a 3.3% standard deviation. Initially low bonds rates have sharply higher probabilities of default.[137] Higher ratings exhibit greater stability — for example, an "AAA" issue has 87.5% chance of remaining "AAA" for 1 year transition period and a "BB" issue has a 70.1% chance to stay in the "BB" rating category. Moreover, originally high rated issuers, on average, experience an increase in default rate only upon the sixth and seventh year outstanding. Both studies show higher risk premium for lower rated bonds.[138]

A recent General Accounting Office study ("GAO Study") on the reliability of agencies' ratings of insurance companies compared the ratings of Duff & Phelps, Moody's S & P's. A.M. Best, and Weiss with the financial impairment rate of the insurance companies they rated between January 1992 and September 1994.[139] The

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134 *See* E., Altman and S. Nammacher, *High Yield Fixed-Income Debt Default Experience*, Morgan Stanley & Co., Inc. Fixed Income Division, March 1985, cited in S. & P'S CREDITWEEK, Feb. 20, 1985.

135 *See id.*

136 *See* S & P's, *Corporate Default, Rating Transition Study Updated*, CREDITREVIEW, Jan. 25, 1993 [hereinafter S & P's Corporate Default Rate Study].

137 For example, "B" rated issuers that defaulted did so in an average of 3.5 years, while "AA" rated issuers that defaulted did os in an average of 7.4 years after the original rating was assigned.

138 *See* Lawrence Fisher, *Determination of Risk Premiums on Corporate Bonds*, 67 J. POL. ECON. 217 (1959).

139 *See* GAO Study, *supra* note 108, at 1. The GAO study relied upon a definition of financial impairment used by the National Association of Insurance Commissioners. *Id.* at 2. This report concluded that Weiss, because of its conservative rating ap-

study found that the ratings scales were difficult to compare and could cause investor confusion, since the agencies at times used the same symbol in different relative positions in their scales.[140] The study attempted to gauge comparative responsiveness to changing financial circumstances of insurance companies by measuring the timeliness of downgrading insurance companies, and while a significant time lag existed in the reporting of financial vulnerability by some of the rating agencies as compared with others, there was too little overlap of issuers rated among the rating agencies to draw conclusions for the rating industry as a whole.[141] The study did reveal that there is a wide range of ratings assigned to any one insurance company by the various rating agencies, suggesting that methodologies of rating insurance companies' claims-paying ability have not yet been fully developed.[142]

Also, rating agencies are not reliable predictors of absolute risks. Default probabilities associated with specific letter ratings have drifted over time. Moody's admits that debt ratings neither be proven correct nor incorrect for any one bond.[143] The cumulative default rates of speculative issues have tripled since the 1970's.[144] Moreover, since 1982 the median ratio of earnings to fixed charges per category has decreased, perhaps indicating the common view that leverage is desirable.[145]

Credibility of the ratings is further complicated by the existence of "split ratings."[146] Split ratings may be due to differences in the rating scales; that is, because the rating agencies do not quantify risk, it is difficult to determine whether the highest category at, for example, Fitch, means the same thing as the highest rating cat-

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proach, predicted more frequently the impairment rates of insurance companies upon the first rating. *Id.* at 26, 27. However, the study did not reveal whether Weiss had underrated all companies, thereby increasing the likelihood that unstable insurance companies would be rated lower.

140 *Id.* at 6-7. For example, an "A+" is Weiss's highest rating, Best's second highest rating and Duff and Phelp's and S & P's fifth highest rating. *Id.* at 9.

141 *See id.* at 29.

142 *See id.* at 30.

143 *See* Moody's Comment Letter (S7-24-94), *supra* note 22, at 11. "The test of a rating system is the degree to which ratings as a whole correlate with actual default experience over time." *See id.* at 11, 12.

144 Cantor and Packer, *supra* note 13, at 11, 12.

145 *See id.* at 12, 13.

146 *Id.* at 12.

egory at, another agency such as S & P's.[147] Split ratings can also arise from differing methodologies and judgments.[148] For example, Moody's might give a higher rating to an asset-backed security that is likely to recover most of its principal in default.[149] Similarly, IBCA assigns higher ratings to some non-United States banks than do the American rating agencies because it places a greater value on the foreign government's support of the banking system.[150] Moody's and S & P's are less prone to assigning split ratings given that they are well-correlated at 0.97.[151] Fitch and Duff & Phelps rate approximately half a notch higher on average.[152] These results reveal a difference in the rating scales as well as orderings of credit risk.[153]

More important, historical studies have focused primarily on correlations between bond ratings and issuer default. Historical defaults of commercial paper were not conducted by the agencies until 1989 upon a dramatic increase in commercial paper default.[154] Empirical studies of ratings for asset-backed securities, mortgage-back securities, and municipals, however, have not yet been performed.[155] Traditional ratings do not take into account cyclical or market variability, to which these newer products are more sensitive. Interruptions in the ability to pay off issuances of these new products, moreover, involve factors which rating agencies do not analyze, to which they do not have access, or in which

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147 *See id.*

148 *See id.*

149 Cantor and Packer, *supra* note 13, at 13. Since the qualitative assessments of issuers depend largely upon whether a rating agency's analytic team deems management credible and capable, split ratings may simply result from differing normative judgments. *See id.* at 21.

150 *Id.*

151 *Id.* at 14.

152 *Id.* at 15.

153 *Id.* at 14.

154 *See* Moody's Investors Service, *Commercial Paper Defaults 1970-1993*, (Special Report) (February 1994). From 1970-1993, only four issuers rated Prime defaulted; downgrades, however, occurred only several days before default. *Id.* Commercial Paper rated not prime defaulted with a loss to investors of $113 million. *Id.* The study did not analyze whether commercial paper ratings were statistically correlated to defaults since only 27 defaults in commercial paper were analyzed. *Id.*

155 Telephone interview with Janet D. Zimmerman, Director of Market Service, Fitch, March 13, 1995. The data pool for studying historical default rates of issuers of structured financings is not yet developed enough to yield conclusive results. *Id.*

they have little experience.[156] In addition, the market for rating these newer products, is not as open as the market for rating bonds because federal regulation, in effect, restricts the rating market to only NRSRO designated agencies.[157]

Part II: The SEC's Regulation of NRSROS: Designation and Registration

Ratings-dependent regulations rely on ratings issued mostly by NRSROs. NRSROs were first used by the SEC in 1975 to refer to rating agencies whose credit ratings could be used in implementing the net capital requirements for broker-dealers in Rule 15c3-1, under the Securities and Exchange Act of 1934 ("Exchange Act").[158] Rule 15c3-1 was also the first instance in which high ratings by the rating agencies resulted in more favorable regulatory treatment.[159] At the time, the SEC was referring to three agencies, Fitch, Moody's, and Standard and Poor's, which had a national presence in the ratings market. Additionally, in a no-action letter, the SEC stated that "no question will be raised by the Division" when such organizations issue ratings for the purpose of subdivision (c)(2)(vi)(E) of Rule 15c3-1.[160] In essence, the SEC grandfathered the then, existing rating agencies into a designation

156 *Id.* Most rating agencies explain the lack of study of ratings for structured financings securities as a result of a immature market, with too little data and too few years to analyze correctly. *Id.*

157 *See supra* note 291 and accompanying text.

158 15 U.S.C. § 78a (1995); *see* 17 C.F.R. § 240.15c-1 (1975); *see* Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirement for Certain Brokers and Dealer, Exchange Act Release No. 11497 [75-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,212 (June 26, 1975); 40 Fed. Reg. 29,795 (July 16, 1975); NRSRO Release, 59 Fed. Reg. 46,314; *see also*, Notice of Revisions to Proposed Rule 15c3-1 and Notice of Proposal to Adopt an Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11094, [74-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,006 (Nov. 11, 1974).

159 *See* 17 C.F.R. § 270.2a-7, Amendment enacted in 1991, and 17 C.F.R. § 239.13 (1993). Under Rule 15c3-1, broker-dealers' nonconvertible preferred stock are accorded preferential treatment in the form of reduced "haircuts" if the instruments are rated investment grade by at least two NRSROs. 17 C.F.R. § 240.15c3-1(c)(2)(vi)(E) (1975); 17 C.F.R. § 240.15c3-1(c)(2)(vi)(F) (1975); and 17 C.F.R. § 240.15c3-1(c)(2)(vi)(H) (1975).

160 Lehman Commercial Paper Incorporated, SEC No-Action Letter, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,513 (March 18, 1976). Although Fitch, S & P's and Moody's provide ratings for the purposes of all regulations which rely in ratings from NRSROs, no official extension of the NRSRO has been obtained from the SEC. *See* NRSRO Release, *supra* note 18, at 46,316.

without a systematic review of predetermined criteria. Because the SEC had these rating agencies in mind when drafting the legislation, the initial designation process of clarifying status through an informal exchange of letters seemed logical. Since that time, however, the Division has utilized the same no-action letter process, which was intended only to clarify status, as a vehicle for determining whether a rating agency meets certain criteria. Such an inquiry demands greater fact-finding and pronunciation of standards. Rule 15c3-1 itself provided no workable definition of NRSRO, no indication of how a rating agency would become an NRSRO, nor any formal mechanism for monitoring the rating agencies after designation.[161]

Since that time, regulators other than the SEC have coopted that undefined term. Even Congress used the undefined term in its definition of a "mortgage related security" as legislated in the Secondary Mortgage Market Enhancement Act of 1984 as amended ("SMMEA") which required, among other things, that a mortgage related security be rated in one of the top two categories by at least one NRSRO.[162] Since Congress intended to grant preferential treatment to mortgage related securities through SMMEA, a high rating by an NRSRO becomes a crucial threshold determination. Further, in 1989, Congress added the term NRSRO to the Federal Deposit Insurance Act to further define the words "investment grade" in the context of the permissible activities of a savings association.[163] In order to become more competitive in the rating industry, rating agencies, both domestic and foreign, are therefore under pressure to seek designation as an NRSRO.[164]

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161 *See* NRSRO Release, *supra* note 18, at 46,314. In some subsequent regulations, the SEC stated that the term NRSRO should have the same meaning as it does in Rule 15c3-1. *See, e.g.*, Rule 2a-7 under the Investment Company Act of 1940, 17 C.F.R. § 270.2a-7 (1991) (the term NRSRO is defined to mean any NRSRO "as that term is used in Rule 15c3-1 . . . . ").

162 15 U.S.C. § 78c(a)(41) (1995). Mortgage related securities, defined in Security Act § 3(a)(41), are known as "SMMEA securities." *See* Risk-Based Capital Requirements-Recourse and Direct Credit Substitution, OCC Proposed Rules, 59 FED. REG. 27,116, at 27,124. *See also infra* note 326.

163 12 U.S.C. § 1831e(d)(4)(A) (1994). Under this section, a security is not of investment grade unless it is rated in one of the top four categories by at least one NRSRO. *See id.* § 1831e(d)(4)(C).

164 *See SEC Set to Issue Concept Release on Regulating Rating Agencies*, SEC WK., VOL. 21, No. 33 (Aug. 15, 1994). Commissioner Roberts considers the status of rating agencies as NRSRos an internationals trade issue. *Id.*

Furthermore, since 1975, as the public bond market has grown, the number of rating agencies commanding national presence has increased the number of agencies seeking NRSRO status. Thus, in 1982 Duff and Phelps received designation.[165] IBCA and Thomson BankWatch have also received a limited form of designation, restricted to ratings for banks and financial institutions.[166] Currently, there are only six designated NRSROs: Thomson BankWatch, Duff & Phelps, Fitch, IBCA, Moody's and S & P's.[167] Two of these, Thomson BankWatch and IBCA, have received limited designations, for the rating of financial institutions, limited to Rule 15c3-1 determinations.[168]

Although the SEC coined the term NRSRO, its widespread usage in other regulatory schemes brings the SEC's jurisdiction over NRSROs into question. The SEC in 1975 left the term largely undefined; without an explicit definition, other regulators could adapt the term NRSRO to specific situations and entities over time.[169] Most federal regulations relying upon NRSROs specifically defers to the SEC's authority in designating rating agencies. Because it has expertise in analyzing conflict of interest and market structure issues generally as well as two decades of experience in NRSRO supervision, the SEC is in the best position to continue any future expanded oversight of NRSROs.

The no-action letter process, while "intensive,"[170] has been de-

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165 *See* Duff & Phelps Credit Rating Co., SEC Non-Action Letter, unpublished, (Feb. 24, 1982) [hereinafter Duff & Phelps No-Action Letter]. In 1983, the firm of McCarthy, Crisanti and Maffei was granted an NRSRO designation; however, that rating franchise was later acquired by Duff and Phelps in 1991. *See* McCarthy, Crisanti and Maffei, SEC No-Action Letter, unpublished, (Sept. 13, 1983).

166 *See* IBCA Limited, SEC No-Action Letter, [90-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,624, 77,824 (Nov. 27, 1990) and (Oct. 11, 1990). Currently, IBCA is designated an NRSRO only for the purposes of applying Rule 15c3-1 to bank supported debt and issued by banks, holding companies, United Kingdom building societies, broker-dealers, and broker-dealer's parent companies. *See id.* IBCA was the first rating agency to be granted limited NRSRO status for the purposes of Rule 15c3-1. *See also,* Thomson BankWatch No-Action Letter, *supra* note 80. Likewise, Thomson BankWatch is recognized as an NRSRO only for the purpose of rating debt issued by banks, bank holding companies, non-bank banks, thrifts, broker-dealers and broker-dealers' parent companies. *See id.* at 78,598.

167 *See* NRSRO Release, *supra* note 18.

168 IBCA Limited, Fed. Sec. L. Rep. ¶ 79,624 at 77,824; Thomson BankWatch No-Action Letter, *supra* note 80, at 78-597.

169 *See* Cantor and Packer, *supra* note 13 at 8.

170 *See* Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission

scribed by both SEC commissioners and commentators as lacking "transparency"[171] and "not very explicit."[172] The applicant for an NRSRO designation usually requests the designation through a letter to the Division. The Division then sends a two-page guideline, entitled "Outline for Rating Agencies of Certain Factors Examined" (the "Outline"),[173] to assist the applicant in assembling the necessary information.[174] The factors listed in the Outline generally indicate the types of problems with which the SEC is legitimately concerned.[175] Some of the factors prove potential sources of conflict of interest, including compensation of employees, corporate organization and ownership, data collection, fees and billing, and instigation of the rating process. The inquiry into these matters targets how independent the rating agency is from issuers, and how concerned the agency is with maintaining that independence.[176] Other factors contemplate publicized reasons for past failures in the rating industry, such as rating surveillance to correct perceived "lethargy" in downgrading securities[177] and compliance with legal requirements with regard to confidential information.[178]

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from Gary L. Granik, on behalf of Davis Polk & Wardwell, Attorneys (Aug. 4, 1992) (Comment File No. S7-12-92).

171 *SEC Proposes Ratings Disclosure, Publishes Concept Release on* NRSROs, BNA SEC. L. DAILY (September 1, 1994) (quoting SEC Commissioner Mary Schapiro).

172 Cantor and Packer, *supra* note 13, at 8. The SEC will investigate an agency that desires NRSRO designation by examining information provided to the SEC from the agency regarding its ownership, history, employee, internal procedure, policies and financial resources. *Id.* However, the SEC's "principal test" is that the agency already be nationally recognized as an issuer of reliable ratings by the predominant users of ratings. *Id.*

173 The Outline is available upon request from the Division and is appended here as Appendix A.

174 *See id.*

175 *Id.*

176 *Id.*

177 *See, e.g.*, Frank A. Bottini, Jr., *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies.* 30 SAN DIEGO L. REV. 579, 584-588 (1993) (Indicating that S & P's was criticized for a delay in downgrading Washington Public Power Supply after WPPSS defaulted on $2.25 billion of the bonds, equaling the largest bond default); Victor F. Zonana, *Are the Watchdogs Watching?*, L.A. TIMES, *supra* note 132 (sluggishness in responding to downturns in an issuer a result of incompetence, fear of contributing to the cost of the issuer's capital, or collegiality with the issuer); Wire Reports, SEC *Eyes Ratings Oversight*, USA TODAY, August 24, 1994 (quoting Commissioner Richard Roberts as citing the insurance industry failures as evidence that the ratings agencies "have been slow to react to deteriorating conditions.").

178 *See, e.g.*, Husisian, *supra* note 1, 414-5 (1990).

Some of these factors, perhaps as a representation upon which the SEC could later base an administrative procedure to revoke the designation, attempt to elicit the character of the agency. For example, the SEC requires each applicant to state its opinion on the proper uses of debt ratings and its opinion on "characteristics an NRSRO should possess."[179]

Although, not listed in the Outline, the Division emphasized in other documents, the most important factor assessed, whether the rating agency is in fact "nationally recognized by the predominant users of ratings" as providing a reliable rating service.[180] While the SEC's usage of the term NRSRO requires applicant rating agencies to demonstrate that their ratings are commonly used within an industry (usually by listing current clients), Moody's suggests that national recognition should mean the ability to impact bond prices.[181] Moody's formulation, a more objective standard, would require applicant rating agencies to demonstrate that ratings they assign correspond to interest rates investors have actually demanded.[182] With S & P's and Moody's already rating the most significant long-term debt issuers and municipalities, it would be difficult for newer rating agencies to prove that their rating alone resulted in the market setting a certain interest rate. Furthermore, as products become more complex, ratings evaluating credit risk should become only one of many factors in determining the price an investor is willing to accept. Such a causal requirement may be impossible to show. The SEC could instead require the applicant to show its competence by providing statistically meaningful studies correlating its ratings to historical default rates. Requiring a history of ratings statistically long enough to demonstrate competence is an objective requirement that elicits whether the ratings are use-

179 *See* Outline, *supra* note 173 and accompanying text.

180 NRSRO Release, 59 Fed. Reg. 46,314, at 46,316; *see, e.g.*, NRSRO Release, *supra* note 18. Letter of Inquiry to Michael Macchiaroli, Securities and Exchange Commission from Chaiyawat Wibulswasdi, Acting Governor and Acting Director, Department of Economic Research, Bank of Thailand (Oct. 22, 1992) [hereinafter Thailand Inquiry Letter and Response] ("[T]he single most important criterion is that the entity be in fact recognized in the United States by the preeminent users of rating services as a credible and reliable source of ratings."). This factor is not emphasized in the Outline.

181 Moody's Comment Letter (File Comment No. S7-23-94), *supra* note 22, at 12. *See, e.g.*, Duff & Phelps No-Action Letter (listing letters of reference from the NAIC and bank examiners to demonstrate national recognition.

182 *See id.*

ful to investors, without intruding into the substance of the rating process.

Regardless of how the "nationally recognized" requirement is formulated, it is clear that the rating agency must be known and widely used in the United States; thus, making it almost impossible for foreign rating agencies with experience rating only foreign securities, to become NRSROs.[183] While NRSROs in the United States may provide a useful service of calibrating foreign securities and assessing accounting information in accordance with industry standards, methodologies already differ across NRSROs, often leading to split ratings.[184] As more securities of international origin are offered in the United States, however, the requirement to be rated by a NRSRO in order to access the integrated disclosure system for foreign issuers may protect the U.S. rating agency industry from foreign competition.[185] A possible solution is to define categories of limited NRSRO status that require limited "national recognition" as previously granted to Thomson BankWatch for United States banks and IBCA for international banks.[186] Another solution the SEC has employed recently in the multijurisdictional context with Canada is to recognize *de facto* certain Canadian rating agencies in a bilateral arrangement.[187] Bilateral agreements recognizing the rating agencies of one country in exchange for their recognition of the NRSROs would rely on each country's market forces and regulation.[188]

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183 *See* Cantor and packer, *supra* note 13 at 8. In fact, some foreign rating agencies failed to become NRSROs on this basis. *See, e.g.*, Thailand Inquiry Letter and Response, *supra* note 180, at 2.

184 Cantor and Packer, *supra* note 13.

185 Already Nippon Investors Service Inc., a Japanese provider of rating services, has pointed out that only one overseas rating agency has been designated an NRSRO and refers to the U.S. rating market as a "oligopoly for agencies previously recognized." The result, according to Nippon Investors Service Inc., is that U.S. investors receive too little investment guidance from rating agencies. Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission from Itsuo Yamamoto, Managing Director, Nippon Investors Service Inc. (Dec. 1, 1994) (Comment File S7-24-94) [hereinafter Nippon Comment Letter].

186 Letter to Jonathan G. Katz, from Nippon Investors Service, Inc., *supra* note 185, at 3.

187 *See infra* note 271 and accompanying text.

188 *See* 56 Fed. Reg. 30,036 at 30,037. Japan currently has a system to designate rating organizations that requires rating agencies to show a track record of rating bonds in the rating agencies domestic currency and to be in line with international standards, an inquiry focusing on organizational structure and processes for handling

After the data has been submitted, the Division reviews the information the applicant provides to it, usually without an independent investigation or proof of accuracy, to determine whether the agency can be designated an NRSRO.[189] During the review period, the Division, however, may inspect the premise or solicit more information from the applicant to clarify the application.[190] If the Division is satisfied that the applicant has met the criteria, then it advises the Commission of its intention to send a non-action letter to the rating agency.[191] If the Commission does not object, then the Division issues the letter granting the designation and makes both the initial request for a determination and the rating agency's opinion letters available as a public record after a thirty day confidentiality period.[192] Once the applicant's file is complete, the designation process takes approximately thirty to sixty days.[193]

The no-action letter that designates a rating agency as an NRSRO is specifically predicated on the factual representations the agency makes in the designation process.[194] The Division requires the rating agency to update this information upon any material change in these facts.[195] In so doing, the Division may revoke the designation if warranted.[196] However, the Commission acknowledges that in practice the information it receives from the NRSROs

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nonpublic information. *See* Nippon Comment Letter, *supra* note 185, at 2-3. Japan's Ministry of Finance has recognized three domestic rating agencies as well as all six NRSROs in reliance on the NRSROs' track record in their own country and in rating instruments denominated in their own currency. *See id.*

189 *See* Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019, 1028, Section of Business Law of the American Bar Association (1987). Although Coffee suggests that information provided by the issuer is often exaggerated and misleading, since ratings remain correlated to default rates, it is possible that rating agencies effectively assess and discount any bluster. *See* Coffee, *supra* note 4, at 746.

190 *See, e.g.*, Thomson BankWatch No-Action Letter, *supra* note 80, at 78,596 (detailing an effort to harmonize BankWatch's credit ratings to those provided by other NRSROs by introducing short term ratings if the SEC designates BankWatch an NRSRO). Usually such additional information must be communicated in writing. *See* Lemke, *supra* note 189, at 1028.

191 *See, e.g.*, *Debt Rating Agencies Should be Subject to More SEC Regulation, Roberts Asserts*, 24 Sec. Reg. & L. Rep. 485 (April 10, 1992) (citing Commissioner Roberts' understanding of the designation process).

192 *Id.* Lemke, *supra* note 189, at 1030.

193 *Id.*

194 *See* NRSRO Release, *supra* note 18.

195 *Id.*

196 *Id.*

themselves is limited.[197]

Although informal and comparably cost-effective, the no-action letter process, in so far as it serves as a fact-finding inquiry of potential conflicts of interest and as a clear articulation of objective standards, fails to establish a system lacking arbitrariness. As with other no-action letters, designations do not represent the SEC's view on the merits of the legal arguments; they are only a recommendation to the Commission not to pursue enforcement on the transaction.[198] In other contexts, the party requesting a no-action letter usually has three options: 1) abandon the project; 2) proceed with the project regardless; or 3) appeal the no-action letter internally at the SEC.[199] A rating agency, however, cannot "abandon" or "proceed" because it is seeking a status determination rather than a transactional determination.[200] As a practical matter, therefore, the only available option becomes internal appeal.

Internal appeals of no-action letters proceed on three levels — review by the staff, review by the Commission, and review by the courts.[201] Appeals performed by the same staff usually result in the same determination unless there has been a misunderstanding as to the facts.[202] In the next step review is made by the Commission, which usually declines to review a staff decision.[203] The appellant reaches the third level of appeal, judicial review, only if the Commission review the staff decision.[204] In effect, the no-action letter process for designating NRSROs represents a final unreviewable decision.

As a review of the integrity of the NRSRO, the designation process places the SEC's imprimatur on the standards employed by the NRSRO and, subsequently, on the ratings it publishes. As a result, the SEC has conferred upon each NRSRO significant economic

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197 *See* NRSRO Release, *supra* note 18, at 46,316.

198 *See* Lemke, *supra* note 189, at 1022.

199 *See id.* at 1031-1039.

200 Failure to obtain an NRSRO status determination does not affect the current operation of the rating agency in the sense that it will still be able to continue its practice. However, earning as NRSRO designation is virtually a prerequisite for rating certain kinds of products or certain issuers. *See infra* note 291 and accompanying text. The rating agency would be unable to proceed in calling itself an NRSRO without the designation.

201 Lemke, *supra* note 189, at 1036-49.

202 Lemke, *supra* note 189, at 1036.

203 *See* Lemke, *supra* note 189, at 1039.

204 Lemke, *supra* note 189, at 1039-40.

and market benefits, without which an undesigned rating agency cannot effectively compete.[205] This is especially true in specialized ratings markets in which a profitable issue largely depends on a favorable rating by an NRSRO.

As an informal process, the no-action letter designation initially provided the Division with an opportunity to become informed about market practices and changing circumstances. Because designation decisions would not be binding on the SEC, the no-action letter process acted as a means for the staff to develop new policies at a low cost. For these reasons, the no-action letter process represented a logical regulatory structure as the SEC was developing its expertise in understanding the rating agencies. Although the no-action letter designation process had demonstrable cost advantages, it results in a vague and opaque process which operates as a protection of the U.S. rating industry against foreign competition. This is apparent in the *ad hoc* grandfathering of Moody's, S & P's, and Fitch.[206] Without a clear set of criteria, the no-action letter designation process appears murky. The process gives undesignated rating agencies the opportunity to claim that denials are unfair restrictions of competition.[207]

In addition to the no-action letter designation process, the Division also requires the rating agency seeking an NRSRO designation to register as an investment advisor under the Investment Advisers Act 1940 (the "Advisers Act").[208] However, if challenged, the SEC might be found to lack the authority under the Advisers Act to *compel* registration of the NRSROs in light of *Lowe v. SEC*.[209]

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205 *See, e.g.*, Letter to Jonathan G. Katz, Secretary, Securities and Exchange commission from Brian I. Neysmith, Canadian Bond Rating Service (Nov. 10, 1994) (Concept Release File No. S7-23-94).

206 Moody's seems to disapprove of Fitch's NRSRO status because Fitch's scale is not correlated to Moody's. On average, Fitch's rates long-term debt half a notch higher than Moody's. Moody's Comment Letter, *supra* note 22, at 5 n.4.

207 *See SEC Proposes Ratings Disclosure, Publishes Concept Release on NRSROs*, BNA Sec. L. Daily, Sept. 1, 1994.

208 15 U.S.C. 80b-1 (1995); *Rating Agencies: Roberts, Schapiro Seek Legislation*, BNA Sec. L. Daily, August 14, 1994.

209 472 U.S. 181 (1985). The Supreme Court granted certiorari in *Lowe v. SEC* to deliberate whether the SEC's market control over investment advisers constitutes a prior restraint. *Id.* at 188-89. Ultimately the Court held that the exemption in the Advisers Act eliminated the need to resort to solving the constitutional issue. *Id.* at 208, 211. Three justices, however, would have found that the Advisers Act can not be used to prevent advisers whether registered or not from giving impersonal investment advice under the First Amendment. *See also* Aleta G. Estreicher, *Securities Regulation*

Even if the SEC lacks the authority to compel registration, to receive designated status NRSROs *voluntarily* register investment advisers.

More importantly, the Advisers Act is ill-suited to regulate the NRSROs effectively. In *Lowe*, the Supreme Court held that an exemption designed for a "publisher of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation" included a publisher of a semimonthly newsletter containing investment advice for paid subscribers. The Court determined this publication contained only disinterested commentary and nonspecific advice.[210] The Court relied on both the legislative history to the Advisers Act, which regulates personalized investment advice, and the plain language of the exception for disinterested and regular publications as it is informed by constitutional concerns. The Court cited the personalized character of the relationship between an investment adviser and his clients as a distinguishing feature.[211] An adviser either holds itself out as an investment adviser, receives separate or additional compensation that represents a clearly definable charge for providing investment advice, or provides specific investment advice.[212] An NRSRO, by contrast, assigns ratings which are opinions on the credit risk of an

and the First Amendment, 24 GA. L. REV. 223, 294 (1990) (analogizing the Adviser Act licensing scheme to state licensing of doctors and lawyers); *but see* Nicholas Wolfson, *The First Amendment and the SEC*, 20 CONN. L. REV. 265 (1988) (arguing that proxy statements, accounting documents and registration statements are entitled to full First Amendment protection because corporate speech has many of the same attributes as political and artistic speech). Rating agencies already enjoy First Amendment protection in the tort context because ratings are a matter of public concern. *See* First Equity Corp. v. Standard & Poor's Corp., 690 F. Supp. 256, 258 (S.D.N.Y. 1988) (in rejecting a fraud claim against S & P's for misdescription of an issuer's convertible bonds, the court held that "a publisher is not liable for false reports of matters of public interest absent knowledge of falsity or reckless disregard for the truth.") (quoting Libertelli v. Hoffman-LaRoche, Inc. 7 MEDIA L. REPTR. (BNA) 1735, 1736 (S.D.N.Y. 1981)) *aff'd* on other grounds, 869 F.2d 175 (2d Cir. 1989). In addition, state laws may prohibit rating agencies from accepting money to distort ratings under commercial bribery laws. *See, e.g.*, American Health Systems, Inc. v. Visiting Nurse Association of Greater Philadelphia, 1994 WL 314313 (E.D. Pa.) (June 29, 1994). Recently, NRSROs have resisted proposed regulation of NRSROs as violative of the right to free speech. *See* Moody's Comment Letter (Comment file S7-24-94), *supra* note 22 at 12.

210 The Advisers Act, 15 U.S.C.A. § 80b-2(a)(11)(D) (1990).

211 *See Lowe v. SEC*, 472 U.S. at 207-208.

212 *See* Investment Advisers Act Release No. 1092, 5 FED. SEC. L. REP. (CCH) ¶ 56.156E (Oct. 8, 1987) (distinguishing financial planners from investment advisers).

issuer, not specific investment advice to buy or sell a specific security. Furthermore, these opinions are not made to a particular investor in exchange for compensation from that investor.[213] NRSROs, like Lowe, were not intended to be regulated by the Advisers Act.

To register as an investment adviser under the Advisers Act, an NRSRO must submit an application containing information largely required in the NRSRO designation process.[214] Registration gives the SEC control over entry into the investment advising market as well as oversight and enforcement authority over those willfully making materially misleading statements or omissions, willful violations of other securities laws, or willful aiding and abetting of securities violations.[215] Registrants also are subjected to criminal penalties and injunction.[216] Since tort law imposes a recklessness standard for private rights of action, the Advisers Act does not increase the standard of care NRSROs must employ while making rating assessments.[217] Although the Advisers Act empowers the SEC to compel disclosure or to prevent registered NRSROs from giving "investment advice," registered NRSROs continue to fail to file updates with the SEC.[218] Although not particularly burdensome, the Advisers Act does not mandate the disclosure of either information not already required in the designation process, or an increase the standard of care, and is not effective in compelling more frequent reporting.[219]

Although both advisers and NRSROs have strong reputational interest in remaining trustworthy and credible, the Advisers Act did not contemplate the quasi-public nature of the rating agency, which provides a service to both issuers and investors while functioning as an intermediary in many respects.[220] Arising from an

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213 *See* DEBT RATINGS CRITERIA, *supra* note 40, at 3.

214 *See Lowe*, 472 U.S. at 210.

215 The Advisers Act, 15 U.S.C.A. § 80b-3, 9 (1990). The Supreme Court has denied the existence of a private right of action, thus limiting investors recourse against NRSROs under the Advisers Act. *See* Transamerica Mortgage Advisers, Inc. v. Lewis, 444 U.S. 11 (1979). Since the Advisers Act requires the state of mind of "willfulness," these antifraud provisions do not change the liability standard currently in place in the common law tort of libel. *Cf.* Husisian, *supra* note 1, at 428 n.69.

216 Section 15 of the Advisers Act, 15 U.S.C. § 80b-9(c), (d), and (e) (1990).

217 *See* Husisian, *supra* note 1, at 413.

218 Section 209 of the Advisers Act, 15 U.S.C. § 80b-9 (1990).

219 *Id.*

220 Husisian, *supra* note 1, at 424.

SEC Commission study directed by Congress through the Public Utility Holding Company Act of 1935, the Advisers Act was intended to regulate investment trusts and investment companies.[221] The relationship envisioned between adviser and investor was personalized, involving fiduciary duties. In contrast, to provide an efficient interface between issuers and investors, rating agencies must widely circulate ratings.

By implicitly recognizing the inapplicability of the Advisers Act as well as other securities regulation to ratings agencies, the SEC has had to structure exemptions for NRSROs. For instance, investment advisers, who prepare or certify registration statements, must consent to Section 11 liability under the Securities Act. The Act applies a negligence standard for the making of any false or misleading statements or omissions before their statements can be published in a registration statement.[222] However, NRSROs' ratings, can currently be included in a registration statement without consenting to Section 11 liability under a negligence standard.[223] Because it seems unlikely that allowing suits based on claims of negligence to go forth would end up leading to investor recovery and a negligence standard would encourage litigation, allowing NRSROs exemptions from Section 11 indicates that NRSROs were not contemplated as "experts" rendering investment advice for the purposes of the Securities Act.[224] Such a divergence in liability standards indicates that the Advisers Act is unsuited to regulating NRSROs.

Likewise, Section 205 of the Advisers Act prohibits investment advisers from making any investment advisory contract that provides for compensation "on the basis of a share of capital gains

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221 *See* Report of the Securities and Exchange Commission, Investment Trusts and Investment Companies, Pursuant to Section 30 of the Public Utility Holding Company of 1935, Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939).

222 Securites Act of 1933, 15 U.S.C. § 77a (1995).

223 *See supra* note 191 and accompanying text.

224 Investor suits alleging negligence would have a low probability of succeeding because rating agencies can defend their rating process as an opinion based upon many kinds of research all of which is distilled down into the rating published; defending such suits, however, could be costly. *See* Paul H. Dykstra, *Disclosure of Security Ratings in SEC Filings*, 78 DET. C. L. REV. 545, 565 (1978) (section 11 imposes a duty of due diligence upon experts in verifying statements of fact in registration statements but since ratings are opinions which are not recommendations to buy or sell a security, this standard of care is inapplicable).

upon capital appreciation of the funds . . . of the client."[225] Rating agencies receive remuneration directly from issuers who commonly solicit ratings.[226] Fees charged from issuers normally are a percentage of the size of the issuance, making the fee contingent upon the success of the issuance.[227] The Advisers Act clearly contemplated the prohibition of contingent fees in the securities advisory context because of a similar potential for abuse.[228] The implicit exemption for NRSROs to arrange contingent fees with issuers, in recognition of the collective action problem in fee arrangements, represents another way in which the Advisers Act is an inappropriate regulatory system for NRSROs.

Part III: Regulatory Reliance on Ratings by NRSROS

Although rating agencies have been relied upon in regulatory contexts throughout this century, the term NRSRO as a distinction among rating agencies has been used in the securities regulatory framework only since 1975.[229] The purposes in relying on NRSRO ratings range from determining proper accounting procedure to exempting issuers from regulatory frameworks that compel disclosure to protect common investors. Because the term NRSRO has never been explicitly defined, regulators may be relying on NRSROs for services they cannot or do not accurately provide.[230]

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225 15 U.S.C. § 80b-5(A)(1) (1990); *see* Husisian, *supra* note 1, at 421-22. The agencies rely on information, both public and private, in analyzing financial data. *Id.* From this data, these agencies create a concise symbolic chart depicting the probability that the rated securities will default. *Id.* Such information is useful to informing the public on investment strategies. *Id.*

226 Sherwood, *supra* note 44, at 23.

227 *Id.*

228 *Id.* § 80b-5(b). The arrangement between issuers and rating agencies may not be considered "an investment advisory contract," since the advisory relationship, if it exists al all, does not exist between the issuer and the rating agency, but between the potential investors and the rating agency.

229 Cantor and Packer, *supra* note 13, at 8.

230 Some regulators refer to the term "nationally recognized securities rating agency" without giving a definition or referring to the SEC's jurisdiction to designate. *See* Federal Housing Finance Board, 12 C.F.R. § 910.6 (1993) (allowing regulation to be modified if a nationally recognized securities rating agency has determined that changes in provisions of a bond will not result in the downgrading of its current rating); Housing and Urban Development's Housing Finance Agency Requirements, 24 C.F.R. § 266.100 (1994) (requiring potential Housing Finance Agencies to be rated "top tier" by Standard and Poor's or other nationally recognized rating agencies and to maintain an overall rating of "A" for its bonds).

NRSROs appear in four kinds of regulation: portfolio restrictions, access to the integrated disclosure systems, trading rules, and stopgap measures for newer or unregulated products. The following traces the development of federal regulatory reliance on NRSROs and the services the regulatory structure relies upon the NRSRO to provide.

A. *Portfolio Restrictions*

Portfolio restrictions rely on ratings generally to determine whether a security is too risky for certain financial institutions to hold.[231] If the SEC did not rely on rating agencies for risk determinations in restricting portfolios, it would either attempt to classify the security's risk itself (thereby expending regulatory resources) or it would promulgate regulations that do not take differing risks into consideration (thereby adding costs to the institutions which hold safer securities and to society). Relying on rating in this context, therefore, promotes efficiency as long as the regulation only presumes that the rating measures relative credit risk.

(1) The Net Capital Rule

As noted previously, the promulgation of Rule 15c3-1 in 1975 marked the first SEC reliance on the term NRSRO.[232] Replacing

231 *See generally* 20 U.S.C.A. § 1087-2 (1988) (Student Loan Marketing Association uses NRSROs for safe harbor if the association is rated within the top four categories by two NRSROs and portfolio restrictions of "not less than 75 percent of the aggregate dollar amount of obligations bought, sold, held, insured, underwritten, and otherwise supported in accordance with the authority contained in paragraph (1)(C) shall be obligations which are listed by an NRSRO at a rating below the third highest rating of such organization"); 20 U.S.C.A. § 1132f-1 (1986) ("At least the percentages specified in paragraph (2) of the aggregate dollar amount of bond and debenture issues reinsured by the Corporation shall be issues which, without insurance, are listed by an NRSRO at a rating below the third highest rating of such organization."); 34 C.F.R. § 668.15 (1994) (providing that a positive factor in determining whether an HEA Program is financially responsible would be an NRSRO rating in the highest two categories of credit quality of currently issued and outstanding debt obligations (without insurance, guarantee, or credit enhancement) by an NRSRO); and 12 C.F.R. § 220.2 (1987) (Board of Federal Reserve's Regulation T defines, in part, OTC bond and security in terms of ratings by NRSROs).

232 *See supra* note 158 and accompanying text. Rule 15c3-1's use of rating agencies to determine accounting rules is reminiscent of the OCC's ruling in 1931 that "bank holdings of publicly rated bonds had to be rated "BBB" or better by at least one rating agency if they were to be carried at book value; otherwise, the bonds were to be written down to market value and 50 percent of resulting book losses" were charged against capital. *See* Cantor and Packer, *supra* note 13, at 6. This practice was ex-

net capital ratios and aggregate indebtedness concepts in use for over 30 years, Rule 15c3-1 requires broker-dealers to deduct from net worth certain percentages of the market value, or "haircuts," of their proprietary securities positions when computing net capital.[233] Haircuts serve as an accounting safeguard against fluctuating market prices. Broker-dealers are required to take haircuts on proprietary positions in commercial paper, nonconvertible debt, and nonconvertible preferred securities; the haircuts, however, are substantially reduced if those securities are rated in the highest two categories by at least two NRSROs.[234]

Contemplated as a measure of greater simplification, the reliance on NRSROs in Rule 15c3-1 in effect assumes that bonds, preferred stock, and commercial paper rated in the top two rating categories are less likely to fluctuate in the short term than those securities rated in lower rating categories.[235] Although ratings only measure credit risk and not market risk, empirical studies have concluded that higher ratings, at least for bonds, have more stability than lower ratings.[236] Although a rating agency is not likely to lower a bond rating merely because of short-term fluctuations that do not affect credit risk evaluations, the ratings especially for bonds and commercial paper approximate the risk of market fluctuations for the SEC's purposes.[237] If the SEC had to set a haircut rate without relying on the NRSROs as a proxy for evaluating security fluctuations, the haircut would have to be an average of the substantial reduction for volatile debt and the lesser reduction for stable debt,

panded by the Federal Reserve in 1936 and adopted by the National Association of Insurance Commissioners in 1951. *Id.*

233 *See* 17 C.F.R. § 240.15c3-1 (1995); Adoption of Amendments to Rule 15c3-1 and Adoption of an Alternative Net Capital Requirement for Certain Brokers and Dealers, 40 Fed. Reg. 29,795 (June 26, 1975) (allowing more favorable treatment for commercial paper rated in one of the three highest rating categories by at least two NRSROs and for nonconvertible debt and preferred stock that is rated in one of the four highest categories by at least two NRSROs in computing broker-dealer deductions from net capital worth).

234 17 C.F.R. § 240.15c3-1 (1995).

235 *See* Notice of Revisions to Proposed Rule 15c3-1 and Notice of Proposal to Adopt an Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Release No. 11094 [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,006 (Nov. 11, 1974).

236 *See, e.g.*, S & P's Corporate Default Rate Study, *supra* note 136, at 2. S & P's specifically notes that its ratings represent a credit evaluation that should not be affected by foreseeable short-term fluctuations. *See id.*

237 DEBT RATINGS CRITERIA, *supra* note 40, at 3.

resulting in too substantial a haircut for stable debt, thus increasing its cost. As the newer ratings, such as V-ratings and "r" ratings, are developed to signal and measure market risk with greater precision, the haircut rule may target short-term fluctuations more specifically permitting it to become more refined.

Making federal regulatory benefits contingent upon high NRSRO ratings in the haircut context did not increase demand for NRSRO ratings.[238] Debt not rated by NRSROs became more expensive for broker-dealers to hold and therefore, might have put pressure on debt issuers to seek high ratings from NRSROs to reduce the cost of their capital. Rule 15c3-1, however, targets large, domestic broker-dealers which had already developed a market practice for subsidizing their own research and analysis with the ratings of the then three domestic NRSROs.[239] As such, Rule 15c3-1 probably did not immediately affect broker-dealers' demand for ratings.

(2) Investment Limitations on Credit Unions

The National Credit Union Administration ("NCUA")[240] takes a different approach in regulating investment decisions by relying on SEC-recognized rating agencies to determine which kinds of securities credit unions can purchase for investment.[241] A corporate credit union, for example, can invest in foreign bank deposits and debt obligations if the issuer's short-term rating is at least "A-1" and its long-term debt rating is "AA-."[242] The regulation demands divestiture of material amounts held if the security is downgraded

238 Cantor and Packer, *supra* note 13, at 6 (Table 3).

239 Nippon Comment Letter, *supra* note 185, at 2, 3.

240 12 C.F.R. § 704(g) (1995).

241 12 C.F.R. § 704.6 (1995). Yet another method of regulating capital requirements would be to require a rating agency to rate the institution directly. *See, e.g.*, 40 C.F.R. § 280.104 (1995). For example, the Environmental Protection Agency requires owners and operators of underground storage tanks to have guarantors, usually local governments, issue at least $1 million in bonds, rates investment grade by either S & P's or Moody's. *See id.*

242 12 C.F.R. § 704(g) (1995) The Credit Union Service Organization (CUSO) means an organization that:

> (1) Exists primarily to meet the needs of credit unions; and
> (2) Engages only in business activities relating to the daily operations of the credit union it serves or provides service associated with the routine operation of credit union.

Id.

from "A-1" for short-term obligations and from "AA-" for long-term debt. Moreover, the foreign country must be rated "AAA" for political and economic stability.[243] In addition, domestic short term obligations issued by bank holding companies or corporations must also be rated at least "A-1" and "AA-", respectively, and is subject to similar divestiture requirements upon downgrading.[244] The chief concern of the NCUA is to prevent default of the credit union and the federal regulation is substituting ratings for its own credit risk evaluation. Because empirical data demonstrates that securities rated in these top two categories carry less risk of default and that divestiture is demanded upon downgrading, the federal regulation's reliance upon rating agencies is well-placed. The NCUA could improve the investment limitation rules by requiring swift divestiture of commercial paper upon downgrading because default quickly follows on the heels of downgrading. Because sovereign ratings have not been fully, nor empirically tested, it is unclear if the 'AAA' sovereign rating protects credit unions from investing in unstable regimes or whether it prevents more diverse, yet still safe, foreign investments.[245] Political stability ratings of foreign countries are also subject to split ratings due to rating agencies' different methodologies as well as their different familiarity with foreign countries.[246]

The NCUA subjects credit unions to further portfolio restrictions including limiting purchase of asset-backed securities to those rated "AAA", provided that the average maturity of the asset-backed securities is no more than five years and that asset-backed securities amount to no more than 5% of assets.[247] Credit union investments are subject to risk weighing which again relies on ratings by SEC recognized rating agencies in a fashion similar to Rule 15c-1.[248]

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[243] *See* 12 C.F.R. § 704.6(2)(iii)(A) (1992).

[244] 12 C.F.R. § 704.6 (1995).

[245] *See, e.g.*, Cantor and Packer, *supra* note 13, at 9 (Historical default studies of issuers of bonds have been conducted because of the immense investor interest in the bond market. Similar interest has not been forthcoming in the field of sovereign ratings).

[246] *See generally* Cantor and Packer, *supra* note 13, at 13 (discussing differences between Moody's rating criteria and that IBCA).

[247] *See infra* note 291 and accompanying text.

[248] *See, for example*, 12 C.F.R. § 704, app. a. (1992). For example, a security issued or unconditionally guaranteed by a foreign government will be risk-weighted at zero only if the political and economic stability of the country is rated "AAA." *Id.*

(3) The Eligible Securities Rule

Rule 2a-7, pursuant to the Investment Company Act of 1940 ("Company Act"),[249] using ratings by NRSROs to determine which securities money market funds are eligible to invest for the money market fund to continue to utilize the penny-rounding method of pricing.[250] Rule 2a-7 relies on NRSROs to determine "eligible securities," or securities rated in the highest two categories of ratings by two NRSROs (or just one if only one NRSRO rates the security).[251] Management can overcome low NRSRO determinations but only if proper procedures are in place which are subject to board approval and periodic reviews.[252] If a security is not rated by NRSROs, it is eligible only if the money market fund's board of directors make factual determinations that the security's issuer "presents a minimal risk of default."[253] NRSROs also distinguish between First and Second Tier securities under Rule 2a-7 to set diversification requirements.[254] A security whose issuer is rated in the highest category with respect to short-term debt by an NRSRO is a First-Tier security not subject to the more stringent portfolio restrictions imposed on Second-Tier securities.[255] Furthermore, Rule 2a-7 requires money market fund managers to reassess the security if it is downgraded at all or if a previously unrated security obtains a rating in a category lower than the highest two categories.[256]

Rule 2a-7 relies on NRSROs to determine which securities are safe enough for a money market to acquire.[257] Although ratings

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249 15 U.S.C. § 80a-1 (1995).

250 *See* 17 C.F.R. § 270.2a-7 (1991). Currently, if a security were rated in the highest category, the board of directors would still be required to make a factual determination that the security did not pose more than a "minimal credit risk" by conducting cash flow, liquidity and worst case scenario tests. *See* Edward T. O'Dell, *Money Market Funds: Amortized Cost Valuation, Credit Risk Analysis and Proposed New Rule 2a-7,* C550 ALI-ABA 169 (Oct. 5, 1990).

251 17 C.F.R. § 270.2a-7(a)(5) (1991).

252 17 C.F.R. § 270.2a-7 (1991).

253 17 C.F.R. § 270.2a-7(a)(5)(ii)(A) (1991).

254 *Id.* § 270.2a-7(a)(6), (14) (1991).

255 *Id.*

256 17 C.F.R. § 270.2a-7(c)(5)(i)(B) (1991). *See* Amendment to Rule 2a-7 Under the Investment Company Act, Investment Act Release No. 18080, [1990-91] Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,720 (Apr. 8, 1991) (excluding tax exempt money market funds from requirement that board ratify acquisition of unrated securities or securities only rated by one NRSRO).

257 *See* Revisions to Rules Regulating Money Market Funds, Securities Act Release

assess only the likelihood of disruption to the payment stream and not short-term fluctuations, empirical studies indicate that bonds rated in the two highest categories have 87.5% probability of maintaining the rating.[258] Unlike the NCUA, however, Rule 2a-7 does not contain a mandatory divestiture procedure for downgraded securities.[259] Whereas the NCUA prohibited the holding of downgraded debt, Rule 21-7, as a safe harbor for using the penny-rounding method of pricing, must offer certainty after meeting its requirements. Although conditioning the pricing method of a money market fund upon maintenance of a rating would seem at first glance to limit the certainty Rule 2a-7 was designated to achieve, mandatory divestiture following a downgrading could have been designed to find no violation of Rule 2a-7 if the divestiture occurred within a defined period of time. Since money market funds are short-term investments, however, required divestiture may not be as important as in the credit union context. In place of required divestiture, management is compelled to reevaluate for suitability securities that have been downgraded.[260] Reliance on management allows funds to engage in riskier investments with higher yields within the diversification requirements.

B. *Access to the Integrated Disclosure System*

Access to the integrated disclosure system is predicated on both issuer and transactional requirements including reporting history.[261] Ratings replace the requirement that a certain dollar amount of voting stock be outstanding, which itself is a proxy for investor surveillance.[262] As long as NRSROs regularly review issuers and publish updates, reliance on ratings to follow issuers is well-placed.

(1) The Integrated Disclosure System

Registration under the Securities Act on Form S-3 allows regis-

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No. 7038 [1993-94 Transfer Binder] Fed. Sec. L. Rep. ¶ 85,303 OR 84,961 (Dec. 17, 1993); Revisions to Rules Regulating Money Market Funds, Securities Act Release No. 6882 [90-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,710 (Feb. 20, 1991).

258 S & P's Corporate Default Rate Study, *supra* note 136, at 2.

259 *See* rule 17 C.F.R. § 270.2a-7 (1991).

260 17 C.F.R. § 270.2a-7 (1991).

261 *See* Form S-3, General Instructions I(B)(2) & (4), 17 C.F.R. § 239.13 (1993).

262 *Id.*

trants to incorporate by reference to past filings, and thus reduces the cost of an issuance.[263] Access to Form S-3 is limited by both a registrant requirement and a transactional requirement.[264] Usually registrants are reporting companies with previously registered securities under the Exchange Act and the transaction usually is primary offerings for cash if the aggregate market value of the voting stock held by non-affiliates of the registrant is $75 million or more.[265] Reporting companies can issue non-convertible securities rated investment grade at the time of sale by at least one NRSRO without meeting the criterion that non-affiliates hold $75 million or more of voting stock.[266] In the case of issuers of asset-backed securities, registrant requirements mandating a reporting history are waived so long so the asset-backed securities are rated as investment grade.[267]

Similarly, foreign issuers as defined by Rule 405 are allowed to use Form F-2 if either the issuer is a reporting company under Sections 12(b), 12(g), or 15(d) of the Exchange Act, or if the securities to be registered are nonconvertible debt securities rated investment grade by at least one NRSRO.[268] Foreign issuers are eligible to use Form F-3 if, among other things, they are a reporting company under the same provisions of the Exchange Act and have either $300 million of voting stock outstanding or if the issuance to be registered is nonconvertible debt rated by at least one NRSRO as investment grade.[269]

Although correct ratings are predicated upon adequate disclosure of information, investment grade ratings are not used to replace disclosure requirements for nonconvertible securities. Investment grade ratings, in these contexts, are used as proxy for the number of voting shares outstanding which itself is a proxy for public interest in the issuer. Since rated companies are under surveillance by the rating agencies which update the rating at least annually, reliance on ratings as a proxy for public interest is reasonable, especially since disclosure itself is forthcoming.

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263 *See* Form S-3, General Instructions I(B)(2) & (4), 17 C.F.R. § 239.13 (1993).
264 *Id.*
265 *Id.*
266 *Id.*
267 *See supra* note 191 and accompanying text.
268 *See* Form F-2, 17 C.F.R. § 239.32 (1994).
269 *See* Form F-3, 17 C.F.R. § 239.33 (1994).

Ratings, however, should not serve as proxies for disclosure of information which investors need in order to make optimal investment decisions. While ratings are material to the investment decision, a rating is just one opinion speaking only to creditworthiness which is solely one facet in determining whether an investment is suitable.[270] Although ratings add to the efficiency of the securities markets by discouraging investors from replicating the full extent of the research and from relying on the cheaper ratings, ratings signify only credit risks, not the investment suitability which is a factual inquiry for each investor.

(2) The Multijurisdictional Disclosure System

NRSRO ratings are used to determine whether Canadian issuers may use Form F-9 to satisfy certain disclosure requirements by filing those documents required by the Canadian regulatory system.[271] Canadian issuers are eligible for Form F-9 if they: 1) meet reporting and size requirements; and 2) issue investment grade debt or preferred stock for cash or in an exchange offer.[272] The

270 *See* Gordon and Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 817 (questioning the reliance upon rating agencies in Form S-3 because of possible anti-competitiveness of the rating industry and investors' disclosure need of other information besides the distillation of ratings).

271 *See* Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, 56 Fed. Reg. 30,036 (July 1, 1991) (regulations and rules issued pursuant to the Securities Act of 1933).

272 *Id.* at 30,040; *see* 17 C.F.R. § 239.39 (1994). The following blue sky state securities laws have also adopted the multijurisdictional system including the reference to NRSROs: Michigan, Blue Sky Regulations, R 451.803.8 (1978) (multijurisdictional disclosure system offerings, CCH BSLR P 32,483B); Minnesota, Legal Investment Laws, Sec. 61A.28 (1985) (domestic companies, investments, CCH BSLR P 33,902); Minnesota, Legal Investment Laws. Sec. 61A.29 (1983) (foreign investments, CCH BSLR P 33,904); Montana, Blue Sky Policy Statements-Orders-Rulings [Multijurisdictional Disclosure System], CCH BSLR P 36,521]; Nevada, Blue Sky Law, Sec. 90.520 (1993) (exempt securities, CCH BSLR P 38,178); Nevada, Blue Sky Regulations, Sec. 90.408 (Registration statements: Use of financial statements and financial information prepared in accordance with generally accepted accounting principles of Canada, CCH BSLR P 38,453A); [Pennsylvania, Blue Sky Regulations, Sec. 205.021 (1990) (Registration by coordination, CCH BSLR P 48,454]); [Pennsylvania, Blue Sky Regulations, Sec. 606.041 (delegation and substitution, CCH BSLR P 48,579]); [Pennsylvania, Blue Sky Regulations, Sec, 609,037 (Foreign Financial statements, CCH BSLR P 48,594A]); Rhode Island, Blue Sky Law, Sec, 7-11-401 (1990) (exempt securities, CCH BSLR P 50,123); South Dakota, Blue Sky Law, Sec. 47-31A-402 (1993) (exemptions, CCH BSLR P 52,332); Texas, Blue Sky Regulations, Sec. 113.13 (multijurisdictional disclosure system-MDS offerings, CCH BSLR P 55,590C); Utah, Sec. 61-14 (exemptions, CCH BSLR P 57,144); Utah, Blue Sky Regulations, R164-9-2

investment grade debt or preferred stock must be nonconvertible for at least one year, and thereafter if convertible, then only into a security of another class of the same issuer.[273] For the purposes of Form F-9, investment grade can be determined by an NRSRO or "Approved Rating Organization (as defined in National Policy Statement No. 45 of Canadian Securities Administrators, as the same may be amended from time to time.)"[274]

National Policy Statement No. 45 defines "approved rating organization" as the Canadian Bond Rating Service, the Dominion Bond Rating Service, Moody's, S & P's and "any entity recognized by the SEC as a nationally recognized statistical rating organization . . . ."[275] The Canadian Securities Administrators, lacking a national organization, did not set out any other way of evaluating Canadian or foreign rating agencies.[276] As such, the MJDS rules have encouraged Canadian rating agencies to seek NRSRO status.[277]

C. *Trading Rules*

Trading rules, which prohibit certain behavior that could potentially manipulate the market, should not rely on NRSRO ratings as a proxy. Rating agencies do not ensure that broker-dealers will sell the securities of an issuer fairly. While ratings have an impact

(MJDS-Financial statement requirement, CCH BSLR P 57,404A); [Vermont, Blue Sky Policy Statements-Orders-Rulings Multijurisdictional disclosure system (MJDS)]. CCH BSLR P 58,417; Washington, Blue Sky Policy Statements-Orders-Rulings (registrations on form S-3, CCH BSLR P 61,785C); Wisconsin, Blue Sky Regulations, Sec. SEC 7.06 (financial statements, CCH BSLR P 64,616); [UNIFORM SECURITIES ACT, Sec. 402. [Exemptions.] CCH BLR P 5542; UNIFORM SECURITIES ACT, (1985), Sec. 401 (exemption securities, CCH BSLR P 5641)]; California, Blue Sky Regulations, Rule 260.100.3 (request for order of exemption, CCH BSLR P 11,764); Indiana, Blue Sky Law, Sec. 23-2-1-2 (1994), [Exemptions.] CCH BSLR P 24,102; Iowa, Blue Sky Law, Sec. 502.202 (1991) (exempt securities, CCH BSLR P 25,112); Iowa, Blue Sky Regulations, Sec. 191-50,54(502) (rankings or ratings of direct participation programs, CCH BSLR P 25,454); Kansas, Blue Sky Policy Statements-Orders-Rulings (order adopting the multi-jurisdiction disclosure system, CCH BSLR P 26,514).

273 *See supra* note 272 and accompanying text.

274 *See* instruction to 17 C.F.R. § 239.39(a) (1994). The Canadian Bond Rating Service was founded in 1972 and the Dominion Bond Rating Service was founded in 1977.

275 Multijurisdictional Disclosure System, National Policy Statement No. 45, 1 Can. Sec. L. Rep. (CCH) ¶ 80-045 at § 2(5) (Dec. 31, 1995).

276 *See id.*

277 *See Debt Rating Agencies Should be Subject to More SEC Regulation, Roberts Asserts*, 24 Sec. Reg. & L. Report (BNA) 485 (April 10, 1992) (reporting Commissioner Roberts' remarks made to Securities Industry Association Compliance and Legal Seminar).

on security prices and yields, they fail to insulate the security from trading manipulation.

Rule 10b-6 under the Exchange Act generally prohibits underwriters, issuers, broker-dealers and affiliates who are beneficially interested in a distribution of securities from bidding on or purchasing any security which is the subject of the distribution or from inducing others to purchase the securities.[278] Rule 10b-6 exempts certain transactions from this rule, including the initial purchase of securities by an underwriter from the issuer or among underwriters and unsolicited private transactions whether or not a broker-dealer is utilized.[279] Presumably, these transactions are exempt because the need for the transaction is greater than the probability and effect of conditioning the market. Here, ratings are relied upon to exempt transactions in certain securities. In other words, if the securities are nonconvertible debt or nonconvertible preferred stock rated by an NRSRO in a category signifying investment grade, then interested persons can trade in those securities during the distribution.[280] Investment grade ratings in this case are a proxy for determining that the probability and effect of conditioning the market is outweighed by the benefits of such a transaction. The law must envision that, if ratings are published and the market impounds their meaning, affiliate trading will not be able to artificially raise the price of the security because the rating will secure the rate of return regardless of market conditioning transactions. Although both Moody's and S & P's claim that their ratings influence bond prices, ratings do not ensure that price cannot be manipulated. Like the other exemptions which focus on the value and necessity of specific transactions, affiliated trades in investment grade securities should be reviewed transactionally.

D. *Stop-Gap Measures for New or Unregulated Products*

Municipals and newer securities which regulation does not comprehensively address are subject to stopgap measures. These measures aim either to establish parity with fully-regulated securities or exempt the municipals or newer securities from inappropriate regulations.

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[278] 17 C.F.R. § 240.10b-6(a) (1993).

[279] *See id.*

[280] *See* 17 C.F.R. § 240.10b-6(a)(4)(xiii) (1993).

(1) Municipal Securities

Registered investment companies are generally prohibited under Rule 10f-3 of the Company Act from knowingly acquiring securities if the principal underwriter is an officer, director or other employee of the investment company.[281] The prohibition is lifted, however, if the securities are registered under the Securities Act or are investment grade municipal securities, "purchased at not more than the public offering price in the first" business day the security is offered, and offered under firm commitment underwriting.[282] In addition, if the issuer of the municipal securities has been in operation less than three years, the exemption is conditioned upon a rating in the top three categories of an NRSRO.[283]

Reliance on ratings permits investment advisers to invest in municipal securities, considered exempted securities under the Securities Act, on the same terms as non-exempted securities.[284] Although Rule 10f-3 sets out substantive restrictions on price and procedures to be adopted by the board of investment company and requires the transaction to be reported, ratings replace disclosure that normally accompanies registered offerings under the Securities Act.[285] Moreover, higher ratings are relied upon to compensate for less public exposure.[286] Unlike reliance upon NRSROs in the integrated disclosure context, Rule 10f-3 does not envision future disclosure to the extent of an offering memorandum or registration statement.[287] Instead, it requires only transactional disclosure.[288] Although the use of ratings in this context levels the playing field between exempt and nonexempt securities, the reliance on NRSROs may be misplaced because the ratings do not approximate the information required to be analyzed.

(2) Asset-backed and Mortgage-backed Securities

Promulgated pursuant to the Investment Company Act,[289]

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[281] *See* 17 C.F.R. § 270.10f-3 (1993).
[282] 17 C.F.R. § 270.10f-3(a)(2) (1993).
[283] 17 C.F.R. § 270.10f-3(c)(2)(ii) (1993).
[284] 17 C.F.R. § 270.10f-3 (1993).
[285] *See id.*
[286] *See id.*
[287] *See id.*
[288] *See id.*
[289] 15 U.S.C. § 80a-1 (1995).

Rule 3a-7[290] exempts certain structured financings from registering and complying with the Company Act.[291] Prior to Rule 3a-7, structured financings either relied upon the exemption in 3(c)(5) (which is intended to exclude issuers engaged in commercial finance and mortgage banking industries) or obtained an order from the SEC under Section 6(c) individually exempting the transaction.[292] However, those nonexempted structured financings were restricted to sell the issuances in private placements under Section 3(c)(1).[293] Under amended paragraph 2(a) of Rule 3a-7, an issuer of asset-backed securities[294] is not deemed to be an investment company if it issues only fixed income securities that are rated in one of the four highest categories by at least one NRSRO at the time of the initial sale.[295] Thus, a favorable rating by only one NRSRO of an asset-backed securities issuance exempts the transaction from the regulatory scheme.[296]

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290 17 C.F.R. § 270.3a-7.

291 *See* Exclusion from the Definition of Investment Company for Structured Financing, Investment Company Act Release No. 19105 [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,062 (Nov. 19, 1992). Structured financings typically involve several issuers pooling income-producing assets and then usually issuing debt backed by those assets for the purpose of providing the issuers with financing for other projects. *Id.* at 83,500.

292 *Id.* at 83,500.

293 *Id.*

294 *See id.* at 83,501. Asset-backed security refers to:

> a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders.

Id.

Form S-3, General Instruction, I(B)(5), 17 C.F.R. § 239.13 (1993). Pursuant to Section 3(a)(41) of the Exchange Act, which was added by the Secondary Mortgage Market Enhancement Act of 1984, a mortgage related security must, among other things, be rated in one of two highest rating categories by at least one NRSRO. *See generally,* Marsha E. Simms, *Asset Securitization, Asset-Based Financings Including Securitization and Acquisition Financing,* 1995 PLI, Commercial Law and Practice (Jan. 1995) (comparing asset-based and mortgage-based securities).

295 *Id.* at 83,500 and 83,504.

296 *See generally,* Marsha E. Simms, *Asset Securitization, Asset-Based Financings Including Securitization and Acquisition Financing,* 1995 PLI, Commercial Law and Practice (Jan. 1995). In credit securitization, for example, a "senior/subordinated" structure is implemented. *See id.* The process which involves the issuance f an "A" tranche of securities usually rated in the top rating categories, followed by a "B" tranche which is subordinated to the "A" tranche and is usually enhanced by a letter of credit to qualify it as debt for tax purposes. *See id.* The senior/subordinated structure can be used to

While the Company Act addresses concerns of corporate governance and fiduciary duty to investors by fund managers, the exemption of Rule 3a-7 is not predicated on the rating agencies accomplishing *de facto* what registration and compliance with the Company Act would require *de jure*[297]. While NRSROs are only just beginning to develop techniques to gauge market risk, they do offer some slight measure of structural integrity.[298] NRSROs have been concerned with legal structure and safeguards against self-dealing, commingling of funds, overreaching by insiders, and "quality of management."[299] However, all the information, including financial data, is distilled into one overall rating without an explanation or disclosure as to the reasoning for the rating. Moreover, few issuances that did not obtain exemptions were ever offered prior to the adoption of Rule 3a-7.[300]

Successful public issuances of asset-backed securities depend on an investment grade rating from at least one NRSRO.[301] Banks and securities firms, therefore, consult directly with the rating agencies to determine how mortgage-backed and asset-backed securities can be structured to obtain higher ratings.[302] Marked competition has been observed in the form of considerable shifting in market share in the area of rating asset-backed and mortgage-backed securities.[303] To combat what it sees as ratings shopping, Moody's sometimes publishes lower unsolicited ratings in this area.[304] Unlike Rule 15c3-1 and Rule 2a-7, which require the rating to be in one of two highest categories, Rule 3a-7 conditions exemption on a showing of "investment grade" only.[305] The proposed revision of Rule 3a-7 would have required a rating in the two

fit a structured financing into the 3a-7 mold by issuing a highly rated tranche of securities followed by a lesser tranche sold only to accredited investors. *See id.*

297 *See id.*

298 *See id.* at 83,505.

299 *See id.*

300 *See generally* (Comment File No. S7-12-92).

301 *See id.* at 83,506.

302 *See* Cantor and Packer, *supra* note 13, at 19.

303 *See* Cantor and Packer, *supra* note 13, at 19.

304 *Id.*

305 Fed. Sec. L. Rep. ¶ 85,062 at 83,505. In 1989, Congress defined the term "investment grade" as receiving one of the highest four categories of rating by at least one NRSRO in Section 1831e of the Federal Deposit Insurance Act, which prescribes the permissible activities of savings associations through reference to investment grade debt. 12 U.S.C. § 1831e(d)(4)(A) (1995).

highest categories.[306] A commentator responding to the Concept Release emphasized that the rating agency's determination of investment grade involves an assessment of availability of cash flow, and the cash flow tests imposed on the top two categories are similar in procedure with only slightly lower numerical standards for the third and fourth categories.[307] As such, the difference between the top two highest categories and the third and fourth categories is meaningless in terms of availability of funds.[308] The concern, however, seemed to protect the two tranche issuance in which a highly rated A tranche is followed by a lesser rated but still investment grade B tranche. Limiting the exemption to issuances only in the top two rating categories would have eliminated the two tranche approach, thereby increasing the cost of the issuance.

The NRSROs evaluate structured financings differently from other more generic corporate securities by analyzing cash flows and structure of the transaction as well as credit and legal issues.[309] Although many factors are scrutinized, an issuer can structure an issuance of asset-backed securities in order to achieve the highest rating. For example, external credit enhancements can ratchet up an NRSRO's rating even though credit enhancements speak to rights upon default and do not prevent the incidence of default.[310] Rating agencies examine the structure of the financing, the credit risk and potential impairment to cash flows as well as allocation of cash flow under the financing's payment structure.[311] Because an NRSRO's rating responds to structure, it is a common industry practice for NRSROs to collaborate with the issuer in creating a structure to attain the highest possible rating.[312] Because lesser rated tranches can follow the higher rated first tranche, structuring

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306 *Id.*

307 *See* FED. SEC. L. REP. ¶ 85,062 at 83,502 and 83,510; *see also* Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission from Cleary, Gottlieb, Steen & Hamilton, Attorneys (Aug. 6, 1992) (Comment File No. S7-12-92).

308 *See id.*

309 *See* FED. SEC. L. REP. ¶ 85,062 at 83,502 and 83,510; *see also* Letter to Marianne K. Smythe, Director, Division of Investment Management, from Karen Kirchen, General Group Counsel on behalf of Citibank, N.A. (Sept. 25, 1992) (Comment File No. S7-12-92).

310 *See* Fed. Sec. L. Rep. ¶ 84,950 at 82,726-27.

311 *See* Exclusion from the Definition of Investment Company for Certain Structured Financings, Investment Company Release No. 18736, [1991-92 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,950 at 82,726-7 (May 29, 1992).

312 *See generally* Comment File S7-12-92.

the first tranche in order to receive the highest rating becomes crucial.[313] Moreover, NRSROs have developed effective continuous projections for interests in structured financings. For instance, the servicer can commingle funds from the securitized assets with its own assets if its debt rating is equal to or higher than the rating of the securities issued in the structured financing.[314] Upon downgrading the services's rating, the funds must be disentangled or the services must provide a credit enhancement to support its obligations.[315] Ratings from NRSROs on structured financings may be viewed as conservative, because NRSROs require "high over-collateralization levels" to compensate for imprecise assessments of characteristics in non-standard assets.[316] However, the tendency of NRSROs to underrate an issuance in order to compensate for their inability to assess structured financings adequately may be diminished by the increase in competition among NRSROs to provide rating services in the asset-backed securities market.

Rule 3a-7 requires the participation of only one NRSRO.[317] Although the cost of duplicating work by involving more than one NRSRO provides little additional protection to investors since the NRSROs would be performing the same analysis,[318] the prevailing market practice prior to the adoption of Rule 3a-7 was for issuers to seek high ratings from "at least two" NRSROs.[319] In light of split

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313 *See generally* Comment File S7-12-92.

314 *See* FED. SEC. L. REP. ¶ 85,062 at 83,502 and 83,510; *see also* Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission from White & Case, Attorneys (Aug. 3, 1992) (Comment File No. S7-12-92).

315 *See id.*

316 *See generally* FED. SEC. L. REP. ¶ 85,062 at 83,502; *see also* Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission from Cadwalader, Wickersham & Taft, Attorneys (Aug. 3, 1992) (Comment File No. S7-12-92).

317 Fed. Sec. L. Rep. ¶ 85,062 at 83,506.

318 *See* FED. SEC. L. REP. ¶ 85,062 at 83,506; *See, also,* Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Teresa Rae Farley, Vice President, Residential Funding Corporation, GMAC (Aug. 3, 1992); Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Debevoise & Plimpton, Attorney on behalf of The New York Life Insurance Company (Aug. 4, 1992); Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Stroock & Stroock & Lavan (Aug. 4, 1992) (all commenting on propose Rule 3a-7 to Comment File No. S7-12-92). *See also* Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission from Kenneth P. Morrison on behalf of Kirkland & Ellis (Aug. 4, 1992) (requiring two NRSROs would give NRSROs too much control over the structured financing market).

319 *See generally* Fed. Sec. L. Rep. ¶ 85,062 at 83,506 (citing to Comment File No. S7-12-92).

ratings, differing methodologies of rating review, and changes in ratings based on uncertain stress tests and cash flow tests, reliance on more than one agency may not be duplicative. More importantly, observed marked competition in rating asset-backed securities appears to arise from the combination of the regulatory advantages of high ratings and the regulatory requirement of only one NRSRO.[320] Requiring only one rating agency places competitive pressure on rating agencies to compete for the asset-backed securities market and increases the likelihood that issuers will shop for the rating agency's methodology that will yield the highest possible rating for its issuance.

Additionally, Rule 3a-7 also does not condition the exemption from registration and compliance with the Company Act on the maintenance of the high rating by the first tranche.[321] While initially it may seem that not requiring the issuer to maintain its initial high rating gives an incentive to the issuer and the NRSRO to overrate an issuance at time of sale to obtain the exemption, ratings in the top two highest categories for bonds at least have significant staying power.[322] It has yet to be studied whether ratings for asset-backed securities in the highest two categories are also maintained.

In 1992, the SEC expanded the integrated disclosure system and shelf registration process under Rule 415 of the Securities Act by permitting issuers of investment grade asset-backed securities to utilize Form S-3,[323] regardless of reporting history under the Exchange Act.[324] This expansion eliminated the anomaly created by Rule 415(a)(1)(vii), which had allowed shelf offerings for only mortgage related securities, even though other forms of asset-backed securities were of comparable quality.[325] Asset-backed securities derive their preferential treatment somewhat from SMMEA which was intended to encourage the flow of funds into the private mortgage-backed securities market by eliminating needless regulatory hurdles for those securities.[326] Because asset-backed securities

320 *See* Cantor and Packer, *supra* note 13, at 19.

321 17 C.F.R. § 270.3a-7.

322 S & P's Corporate Default Rate Study, *supra* note 136, at 2.

323 *See* 17 C.F.R. § 239.13 (1993). Issuers of investment grade nonconvertible securities are also eligible for Form S-3, if they meet the public float requirement and 12 months of reporting history. 17 C.F.R. § 239.13 (1993).

324 *See* 17 C.F.R. § 239.13 (1993).

325 *See* 17 C.F.R. § 232.415 (1994).

326 Simplification of Registration Procedures for Primary Security Offerings, SEC

closely resemble mortgage-backed securities, the SEC has initiated similar provisions for asset-backed securities in an effort towards conformity.[327] Reporting histories are not utilized for asset-based or mortgage-backed securities, because each offering is usually made by a different issuer with a unique set of financial or real estate assets backing the securities.[328] As such, a reporting history would be of little practical use for investors. Asset-backed and mortgage-backed securities must be investment grade and serviced by the cashflows of a discrete pool of receivables, other financial or real estate assets.[329] Because the only requirement for using Form S-3 for these instruments is that they be investment grade rated by at least one NRSRO at the time of sale,[330] NRSROs, determine the likely prospects of selling asset-backed securities. In lieu of reporting history, Form S-3 mandates the disclosure of five factors: 1) past prepayment of principal rates and the factors that affect rate of principal repayment; 2) the risk that interest-weighted classes bought at a premium may not return the purchase price in the event of rapid repayment; 3) the degree to which an investor's yield is sensitive to principal repayments; 4) the consequences of an increasing prepayment rate in a declining interest rare environment and a declining prepayment rate in an increasing rate environment; and 5) an explanation of what an NRSRO rating

Rel. No. 6943, 57 Fed. Reg. 32,461 at 32,462 (Oct. 22, 1992). Mortgage related securities were targeted in SMMEA in an effort to increase the flow of funds to the mortgage market by removing unnecessary barriers to the creation and sale of private mortgage-backed securities. *See* H.R. Rep. No. 994, 98th Cong. 2d Sess. 14, 4, 8 (1984). As such, mortgage-backed securities have been exempted from a number of securities regulations by virtue of the 3(a)(41) exemption under the Exchange Act. 57 Fed. Reg. 32,461 (1992).

327 *See, e.g.*, 12 C.F.R. 203, Pt. 3, App. A. (1995) (Risk based capital guidelines containing special risk weighing for privately issued mortgage related securities); 12 C.F.R. § 220.2 (1987) (Regulation T); 17 C.F.R. § 230.415 (1995) (allowing special shelf registration of mortgage-backed securities); 17 C.F.R. § 230.424 (1994) (special filing requirements for shelf offerings); 17 C.F.R. § 240.15c3-1 (C)(2)(vi) (1995) (conferring special "haircuts" upon mortgage related securities).

328 *See* 57 Fed. Reg. 32,461 at 32,462.

329 *Id.*

330 *See* 17 C.F.R. § 239.13 (b)(2) (1993). Prior to signing Form S-3, the issuer of asset-backed securities must have reasonable grounds to believe that the securities will be rated investment grade at the time of sale. Reasonable grounds can include, for example, recent ratings assigned to similar class of securities. If the final rating is lower than investment grade, the issuer must file an amendment on Form S-2 or Form S-1.

addresses and the characteristics the rating does not address.[331] NRSRO ratings therefore contribute to an evolving disclosure system geared toward providing meaningful and relevant information to investors.

E. *Disclosure of Ratings*

In 1982, Rule 436 was amended to provide that ratings "assigned to a class of debt securities, convertible debt securities, or preferred stock by an NRSRO would not be deemed part of a registration statement under Section 7 and Section 11 of the Securities Act.[332] In essence, issuers no longer had to obtain consents from NRSROs before publishing ratings and NRSROs were exempt from Section 11 liability if the ratings were included in a registration statement under the Act.[333] Rule 134 under the Securities Act[334]

331 *See* 17 C.F.R. § 239.13 (1993).

332 Disclosure of Security Ratings by Money Market Funds, Securities Act Release No. 6630, [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,973 (March 14, 1986) [hereinafter Money Market Fund Rating Disclosure Release]. 17 C.F.R. § 230.436(g) (1993). Similar measures regulating the publication of ratings by NRSROs comprise the Integrated Disclosure System for Small Business Issuers, Item 10 of Regulation S-B, 17 C.F.R. § 228.10 (1992). Specifically, Items 10 (e)(1)(i) and (e)(1)(ii)(A) recognize the marketplace's reliance on ratings and attempt to encourage small business issuers to provide ratings in their disclosures provided that if any ratings are published: (1) the issuer should include any ratings by other NRSROs that are materially different; (2) "a statement that a security rating is not a recommendation to buy, sell or hold securities and that it may be subject to revision or withdrawal at any time by the assigning rating organization should also be included"; (3) consents must be obtained, but there is no requirement to obtain the consents of NRSROs; (4) changes in a ratings available "before effectiveness of the registration statement" should be included and material rating changes should cause recirculation of the preliminary prospectus; (5) "materially different additional NRSRO rating or a material change in a rating already included becomes available during any period in which offers or sales are being made" should be disclosed in a sticker to the prospectus; (6) after close of the issuance, material changes in the ratings assigned by an NRSRO to any outstanding classes of securities of a reporting company, should be reported on Form 8-K.FN[17 C.F.R. Section 228.10(e)(1)(i) and (e)(1)(ii)(A).] Regulation regarding the publication of ratings provided in Regulation S-K for standard instructions, however, compels disclosure of the identity of the rating agency, the rating agency's explanation of its rating, the relative rank in the rating agency's rating scale as well as the statement informing investors that a rating is not a recommendation to buy or hold a security. *See* Item 10(c) of Regulation S-K, 17 C.F.R. § 229.10(c) (1993).

333 *See* Disclosure of Security Ratings, 43 Fed. Reg. 58,414 (Nov. 3, 1977). This first attempt to permit or require disclosure of ratings in filings was received with hostility and deferred until 1982.

334 17 C.F.R. § 230.134 (1993).

was also amended at that time to allow issuers of debt and preferred stock to publicize ratings by NRSROs in tombstone ads.[335] In 1986, the SEC extended the same treatment to money market funds,[336] and Rule 482[337] was amended to permit the disclosure of ratings of money market funds in omitting prospectuses.[338] Together, the three amendments have eliminated the requirement that money market funds obtain the consent of any NRSRO issuing a rating to the fund before publishing it in a prospectus, exempted NRSROs from liability under Section 11 of the Securities Act, and facilitated the use of ratings in certain advertisements.[339] In the money market fund context, additional information about the rating and NRSRO providing the rating must be disclosed, including the nature of the rating, material changes in the rating, the date of the rating, the availability of materially different ratings and a decision to discontinue the rating.[340] In 1986, only one NRSRO rated money market funds.[341]

The broad exemption of NRSROs from the normal liability provision of Section 11 of the Securities Act signifies that NRSROs are not held to a negligence standard.[342] That is, NRSROs can make negligent mistakes of material fact in their ratings without incurring liability.[343] But, they are still subject to the antifraud provisions such as Section 17(a) of the Securities Act,[344] Section 10(b) of the Exchange Act,[345] and Rule 10b-5 under the Exchange Act.[346] By requiring scienter or at least recklessness, however, the antifraud provisions will not replace the common law tort action for issuers. NRSROs, therefore, are only subject to SEC control through NRSRO designation and Advisers Act registration.

For the rating agencies to effect an interface between issuers,

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335 *Id.* § 230.134(c)(14)(i) (1993); *see* Money Market Fund Rating Disclosure Release, *supra* note 332, at 88,055.

336 *See* Money Market Fund Rating Disclosure Release no 6630, [85-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,973 (March 14, 1986).

337 17 C.F.R. § 230.482 (1991).

338 *Id.* § 230.482(e)(4).

339 *See* Money Market Fund Rating Disclosure Release, *supra* note 332, at 88,055.

340 *Id.* at 88,257.

341 *See* Money Market Fund Ratings Disclosure Release, *supra* note 332, at 88,056.

342 *See id.* at 88,056.

343 *Id.*

344 15 U.S.C. § 77q(a) (1950).

345 15 U.S.C. § 78j(b) (1934).

346 17 C.F.R. § 240.10b-5 (1951).

and investors to assure that the capital markets are working efficiently, ratings must be widely published and used by investors.[347] To save investors the cost of conducting individual research and lower the cost of capital by signaling to investors that an issuer's security is stable, ratings must not only be publicly available, but easily and cheaply available.[348] NRSROs publish their ratings in publications that are sold to subscribers, deposited at libraries, and in certain cases available over a toll-free line.[349] To this extent, encouraging the dissemination of ratings in tombstone ads and prospectuses increase the likelihood this material information will be included in the total mix of information upon which a potential investor will rely when making an investment decision.[350]

Some rating agencies have objected to including NRSRO ratings in the issuer's disclosure documents because it threatens the rating agency's independence.[351] Although the registration package is the issuer's responsibility, other experts certify and attest to particular sections of it without losing their independence.[352] Registration statements are documents to be filled with information of interest to investors, and so are in only a limited sense the purview of the issuer. Rating agencies, moreover, have structured fee arrangements in such a way as to preserve adequate disclosure to

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347 *See* Coffee, *supra* note 4, at 725.

348 *See id.*

349 *See* GAO Study, *supra* note 108, at 7. Further, issuers encourage publication of ratings to ensure that the rating affects its cost of capital; investors press for widespread publication in order to take advantage of the free information represented in a rating; and rating agencies themselves build reputation by increasing their visibility among investors and issuers through wide circulation of ratings. *See generally* Easterbrook and Fischel, *supra* note 4.

350 *See* Dykstra, *supra* note 224, at 557-58 (providing ratings in selling documents and filings caters to the convenience of the investor).

351 *See, e.g.,* Moody's Comment Letter, *supra* note 22 at 10. The letter explained as follows:

> The SEC's proposals as set forth in the Disclosure Release would require rating agencies to become involved in preparing those portions of the registration statements that discuss the meaning of ratings and any material limitations on their scope . . . Converting [the rating agencies] from impartial observers into participants in this process would inevitably compromise their independence and objectivity, thereby directly undermining their utility.

Id.

352 Section 11, Securities Act of 1933, 15 U.S.C.A. 77k(a)-(g) (setting forth liability and account of false registration statement).

the investors but also in a way which raises conflict of interest questions.

Allowing voluntary rating disclosure performed only by NRSROs signals to the investors that the rating is more valuable because of the SEC's oversight and approval process.[353] Assuming that no rating agencies assign unsolicited ratings, if an issuer has a strong security it wishes to offer, it will go to the rating agencies to obtain a rating which will lower the issuer's cost of capital.[354] If the issuer can use the high rating as a selling tool, the issuer will go early to the rating agency to ensure that the rating will be ready for the selling documents.[355] Even if an issuer has a weak security, it will prefer to get a rating as long as the cost of capital for an unrated issuance is higher than the cost of capital with a low rating. Only the issuers of very weak securities would opt not to go the rating agencies because the cost of capital of not going is lower than the cost of capital for an extremely low rating. If only NRSRO ratings can be used as selling tools by the issuer in registration documents, all issuers, except those that offer the weakest securities, would be encouraged to solicit the NRSROs for ratings. Under the proposal, there is little incentive to solicit ratings from nondesignated rating agencies during the primary offering.

The addition of unsolicited ratings may channel the issuers to frequent those NRSROs which would publish them. Since unsolicited ratings, which are materially different from solicited ratings, are required to be disclosed in the money market fund context and lack assessments of nonpublic information including forecasts and plans as well as an evaluation of management, they can be, on the whole, lower than solicited ratings upon the same scale. An issuer of a strong security with positive nonpublic information should seek a rating from the rating agency that assigns unsolicited ratings to signal the information to the market and to lower its cost of capital.

The disclosure of the rating process itself is required if a rating is to be used in a selling effort.[356] Although there is concern that

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[353] *See* Easterbrook & Fischel, *supra* note 4, at 683-685.

[354] *Cf. id.*

[355] *See generally id.*

[356] *See* Disclosure of Security Ratings, Securities Act Release No. 7086, Exchange Act Release No. 34,617; Investment Company Act Release No. 20509, 59 Fed. Reg. 40,304, at 46,307 (Sept. 7, 1994).

the rating process is complicated by rating scale variations, innovative methodologies, and limited scope ratings, disclosure in final prospectuses after the investor has purchased the security will not afford the investor any more protection than that which currently exits.[357] Even if the nature and scope of the rating are disclosed in red herrings, average investors may not read or understand it. On the other hand, mandatory disclosure of the rating process would not be costly because explanations of the changes in the rating process can be largely copied from rating agency weekly and monthly publications. Because it is unclear whether the market has yet been able to impound the information represented in the new rating scale variations correctly, mandatory disclosure of the rating process has not prevented investor confusion since its adoption in 1982.

Part IV: Proposals For Increased SEC Oversight Over NRSROS

In light of investor confusion and the SEC-conferred competitive advantage of NRSROs, legislators and regulators have both suggested more comprehensive regulation of the NRSROs.[358] It has been suggested that replacing the policy of voluntary disclosure with mandatory disclosure of solicited NRSRO ratings, their scope, and material changes in final prospectuses and on Form 8-K would address some of the problems associated with NRSROs, especially the problems of investor confusion.[359] Under this proposal, issuers would be obligated to disclose all NRSROs' ratings obtained, regardless of whether they plan to use the ratings in the selling effort; ratings not solicited by issuers, however, would not be subject to mandatory disclosure.[360] Since issuers receiving strong ratings would have an incentive to make the rating as widely available as

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[357] *See generally,* Dykstra, *supra* note 224, at 555 (Disclosing the intricacies of the rating process allows the investor the opportunity to question the rating process).

[358] *See* Letter to Richard Breeden, Chairman, Securities and Exchange Commission form John D. Dingell, Chairman, U.S. House of Representatives, Committee on Energy and Commerce (Apr. 28, 1992). *See also Rating Agencies Need Regulation and Standards, SEC Official Says,* The Bond Buyer, Apr. 14, 1992 (discussing proposed regulation of NRSROs).

[359] *See* Disclosure of Security Ratings, Securities Act Release No. 7086, 59 Fed. Reg. 40,304, at 46,307. (Sept. 7, 1994) (proposing mandatory disclosure of NRSRO ratings of issuances in final prospectuses) [hereinafter Proposed Ratings Disclosure Release].

[360] *Id.* The Proposal mandates the disclosure of ratings "obtained by or on behalf of the issuer." *Id.*

possible, mandatory disclosure should not alter the frequency of disclosure. Moreover, issuers receiving weak ratings would continue to be able to suppress or withdraw those ratings, if allowed by the NRSRO. Even if the issuer does not allow suppression, an issuer may be able to gauge whether the rating will be low and withdraw the application prior to completion of the rating process. More importantly, unfavorable unsolicited ratings would not be required to be disclosed. Therefore, there is no guarantee that ratings, whether unfavorable or not, would be disclosed more frequently under the mandatory disclosure system.

If mandatory disclosure is meant to protect investors at the margin, it would be more valuable if ratings discussion were disclosed in the preliminary prospectuses before an investor has bought the security. Even without mandatory disclosure, if the available ratings impact the security's price and yield, the investor gets what he pays for — the question is not whether each investor understands the rating process and what the rating means but whether the market successfully impounds the information communicated to it by the rating.[361] In the case of structured financings and new rating scale variations, the market could indeed be slow to impound information conveyed in a rating because of the new methodologies.[362] Since the incidence of rating disclosure will probably not be increased, it is unlikely that requiring disclosure will hasten the market's learning process.

The current proposal requires that ratings from nondesignated rating agencies would also be subject to mandatory disclosure if used in connection with an offer or a sale by any participant in the offering.[363] However, nondesignated rating agencies would remain subject to Section 11 liability and issuers must obtain their consent in order to include the rating.[364] While an issuer should be indifferent between designated and nondesignated rating agencies relying only on market distinctions, issuers would tend to seek ratings from designated ratings because

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361 *See* Easterbrook & Fischel, *supra* note 4, at 694.

362 *See* Proposed Ratings Disclosure Release, *supra* note 359, at 46,307. The Proposed Ratings Disclosure Release cautions that not all security ratings would trigger duties to disclose; credit risk ratings as well as "non-credit payment risks" would constitute "security ratings." *See id.*

363 *See* Proposed Ratings Disclosure Release, *supra* note 359, at 46,307.

364 *See Id.* at 46,307-08.

nondesignated rating agencies will most probably decline to give consent for use in connection with an offer or sale. Assuming Section 11 liability, which means an acceptance of a higher standard of care from recklessness to due diligence, is a costly prospect.[365] Such preferential treatment implies that only NRSROs are so capable and competent that they do not need additional deterrence measures in the rating process.

At the other extreme, rating agencies have proposed that federal regulation should not rely upon ratings at all because such reliance assumes the rating is more than a credit risk evaluation and reliance necessarily interferes with the rating market.[366] Indeed, some regulatory schemes rely on ratings to assess market risks and fluctuations, or as a proxy for disclosure, both of which are functions for which ratings were not intended.[367] Empirical studies show that ratings for certain instruments can be used as a close proxy for short-term fluctuations as well as for credit risk evaluations.[368] The new rating scale variations and methodologies geared to assess market risks and other pinpointed factors will only expand the use of ratings as closer proxies to duplicating empirical analysis. Not relying on ratings now for what historical data demonstrate are empirically correct determinations would result in more costly regulation.

A third proposal focuses not on *ad hoc* disclosure of rating processes but on day to day oversight of the rating agencies. Two former commissioners of the SEC would have approached the NRSRO problem from a registration standpoint.[369] Streamlining and standardizing the designation process, their proposal would define the term NRSRO and emphasize four criteria in registering the rating agencies.[370] First, the regulation would defer to the market for a determination of credibility, requiring the rating agency be rec-

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365 Husisian, *supra* note 1.

366 *See* Moody's Comment Letter, *supra* note 22, at 6-7. Moody's suggests that federal regulatory reliance has a tendency to coopt the rating agency thereby interfering with the agency's independence. *Id.*

367 *Id.* at 9.

368 *Id.* at 4. Moody's would repeal Rule 15c3-1's reliance upon ratings to determine "haircuts." *Id.* at 9.

369 *See Debt Rating Agencies Should Be Subject to More SEC Regulation, Roberts Asserts*, 24 Sec. Reg. & L. Report 485 (April 10, 1992).

370 *Debt Rating Agencies Should Be Subject to More SEC Regulation, Roberts Asserts*, 24 SEC. REG & REPORT 485, (April 10, 1992).

ognized by the preeminent users of rating services as an issuer of reliable ratings.[371] However, preserving the market deference does not solve the problem of protectionism asserted by foreign rating agencies. Second, registration would require a showing that the methodology employed is thorough and credible.[372] Third, registered agencies would publish ratings that are timely and useful. The SEC staff, however, is not competent to review analytical procedures or, worse yet, to interfere with the substance of rating process. Fourth, prior to registration, the organizational structure of the agency would be scrutinized for potential conflicts of interest and internal mechanisms for handling external pressures associated with close issuer contact and the possession of nonpublic information.[373] Implementing such a regimen would call for a legislative grant of authority which could raise significant problems after *Lowe*. More importantly, such a regulatory approach would further stress the SEC's imprimatur on designated rating agencies to the detriment of undesignated rating agencies thereby increasing an already high barrier to entry, especially for foreign rating agencies.

Conclusion

Any designation process will undoubtedly have the effect of creating a hierarchy of rating agencies, but the SEC should minimize the extent to which designation becomes a stamp of its approval. Instead, designation of NRSROs should focus foremost on internal procedures for handling nonpublic information and structural conflicts of interest, without registration under the Advisers Act, which is ill-suited to overseeing NRSROs.[374] Replacing the criterion that NRSROs be indeed "nationally recognized," applicant rating agencies should be required to show empirical studies correlating ratings assigned by the rating agency to interest rates and historical default rates to keep the barrier to entry as low as possible. In addition, the possibility of limited designation for foreign rating agencies to rate securities originating from their countries may only help resolve the protectionist aspect of designation. Like-

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371 *Id.*
372 *Id.*
373 *Id.*
374 *See, e.g.*, Nippon Comment Letter *supra* note 185, at 6, 7.

wise, the designation process should become more transparent and formalized since the current no-action letter process is subject to criticism because it involves subjective and vague criteria. Finally, the designation process should offer a meaningful method of appeal.

Disclosure of ratings lies at the heart of the efficient capital market hypothesis that information be publicly and freely available for the market to impound to lower capital costs and for investors to rely upon in making optimal investment decisions. Currently, ratings are publicly available: as such, requiring disclosure of rating processes in the primary market should be predicated on equalizing the playing field among rating agencies to insure that many raters with differing methodologies give their assessment of the security. Allowing usage of NRSRO ratings without requiring consents from the NRSRO in the selling effort, but compelling other rating agencies to consent to a higher standard of care in order to publicize their ratings in registration documents confers a competitive advantage upon NRSROs without promoting greater efficiency in the capital market.

Federal regulation should rely on ratings which serve as empirically proven proxies for many kinds of risk determination. However, federal regulation should not precede empirical data because reliance on ratings for what they do not evaluate does not accomplish the goals of the regulation and federal regulation should not confuse investors by relying on ratings for more than what the rating actually communicates. Currently, regulators do not even review empirical studies to determine whether reliance on ratings is well-placed.[375] c Prior to enacting regulation which relies upon ratings, regulators should explicitly contemplate whether empirical data supports its delegation to a rating agency as reasonably correct.

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375 *See generally* the Outline, *supra* note 173.

Appendix A
Outline for Rating Agencies of Certain Factors Examined by the Securities and Exchange Commission

I. *Resources*
   A. Organizational Structure
      1. Ownership
      2. Financial Resources
      3. Revenue
   B. Staffing
      1. Professional Staffing
         a. Credentials
         b. Experience
         c. Training and Development
         d. Support Services
         e. Compensation
      2. Support Staff

II. *Rating Agency's Debt Rating Process*
   A. Types of Issues Rated
      1. As a Matter of Policy
      2. On Issuer Request
      3. ON Subscriber Request
   B. Rating Groups
      1. Composition (e.g., corporates, municipals, industrials)
      2. Personnel (including number of analysts) Assigned to Each Rating
   C. Data Collection
      1. From Issuer
      2. From Investment Banker
      3. Database
      4. Records
      5. Public Documents
      6. Other Sources
      7. Access to Information
   D. Analysis
   E. Rating Decision
      1. Basis of Decision
      2. Who Makes Decision
   F. Appeal Process (if applicable)

- G. Dissemination of Rating (Does the issuer have the right to not have a rating published?)

III. *Rating Surveillance*
- A. Surveillance Policy
- B. Rating Changes
- C. Analysis (Does it differ from initial rating analysis?)
- D. Dissemination
  - 1. Of Rating
  - 2. Of Rating's Basis

IV. *Fees and Billing*

V. *Compliance with Legal Requirements*
- A. Chinese Walls
- B. Regulation of Employee Activities
- C. Confidentially of Information Received from Issuer

VI. *Rating Agency's Opinion of the Proper Uses of Debt Ratings*

VII. *Rating Agency's Opinion of Characteristics Which an NRSRO Should Possess*