PRIVATE ORDERING OF PUBLIC MARKETS: THE RATING AGENCY PARADOX

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In this article, Professor Schwarcz examines the role of rating "agencies" in ordering financial markets in the United States and abroad. Though rating agencies are largely unregulated private entities, they significantly influence the global economic system. Recent international proposals regarding the determination of capital adequacy guidelines for the banking industry call for an even greater role for rating agencies. In this light, Professor Schwarcz queries whether market forces provide sufficient restraint on rating agencies or whether public sector regulation is warranted. In the latter case, he also asks whether it is feasible for individual nations to regulate multinational entities of this type.

The article initially addresses the functions, origin and terminology of rating agencies. Through the development and nearly universal acceptance of ratings, investors are able to assess the risk attendant to investments in public and privately issued debt securities. The article then addresses the issue of regulation, focusing on the competing regulatory goals of efficiency and distributional interests. Concluding that any regulation of rating agencies should be largely rooted in efficiency concerns, Professor Schwarcz posits that regulation could increase efficiency by either bolstering rating agency performance or mitigating negative consequences of rating agency misbehavior.

Professor Schwarcz contends that regulation would not increase efficiency. Rating agency costs are not excessive, nor would increased regulation result in greater ratings reliability. Rating agencies are al-

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ready motivated to provide accurate and efficient ratings because their profitability is directly tied to reputation. Conversely, additional regulation could possibly subject ratings to political manipulation, thereby impairing ratings reliability.

The article also rejects the contention that regulation would mitigate any negative consequences of rating agency misbehavior. Although the practice of requiring issuers to pay for a rating raises a potential conflict of interest, Professor Schwarcz argues that the risk of misbehavior is minimal and is largely deterred by the potential impact on reputation costs. He also argues that reputation can be a substitute for regulation, and that, at least for rating agencies, reputation drives much of the accountability that ordinarily is achieved through the democratic process.

Regulation of rating agencies is also unlikely to resolve their traditionally conservative bias against innovative new financial structures. Government regulation may in fact increase the bias by reducing competition among rating agencies. Moreover, given the international nature of rating agencies and the fact that their assets are human capital, regulation by individual nations could drive rating agencies to relocate to foreign nations that do not impose regulation. Professor Schwarcz concludes that public regulation of rating agencies is an unnecessary and potentially costly policy option.

> "The United States can destroy you by dropping bombs, and [rating agencies] can destroy you by downgrading your bonds."[1]

> Rating agencies "have the power to destabilize whole national economies, municipal governments, major corporations."[2]

Rating agencies profoundly impact the ordering of global financial markets. They are the universally feared gatekeepers for the issuance and trading of debt securities,[3] and recent proposals by the Basel Committee on Banking Supervision (the Basel Committee) promise to further expand their role internationally.[4] Yet they remain largely unregulated private entities. This article examines whether rating agencies should remain unregulated and, if not, whether it is feasible for individual nations to regulate multinational entities of this type.[5]

1. Thomas L. Friedman, *A Manifesto for the Fast World*, N.Y. TIMES MAG., Mar. 28, 1999, at 40, 43.

2. Saskia Sassen, untitled and unpublished manuscript on the sociology of rating agencies 4 (June 1999) (on file with *University of Illinois Law Review*) [hereinafter Sassen, Rating Agencies].

3. *See, e.g.*, *The Use and Abuse of Reputation*, ECONOMIST, Apr. 6, 1996, at 18 (noting that "little irks companies and governments more than a visit from the man from Moody's" because rating agencies have "huge powers to move markets") [hereinafter *Use and Abuse*].

4. *See infra* notes 8–12 and accompanying text.

5. In its largest sense, regulation can be divided into self-regulation and government regulation, and the latter can be further subdivided into the administrative system of direct public control and the judicially enforced system of private rights. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 13.1, at 367 (4th ed. 1992). I focus on regulation via the administrative system of direct public con-

Moreover, rating agencies are members of the "new set of [largely, though not exclusively, private] intermediary strategic agents [that] have absorbed some of the international functions carried out by states in the recent past."[6] To this extent, they are representative of a growing trend toward private ordering of traditionally public functions.[7] Thus, this article's analysis will have implications for private ordering by non-governmental organizations (NGOs) beyond rating agencies.[8]

I. INTRODUCTION

A. The Problem

Investors in domestic and cross-border financial transactions increasingly rely on rating agencies for substantial comfort regarding the risks associated with the full and timely payment of debt securities.[9] A rating agency's assessment of these risks may involve analyzing the structure of the transaction and any underlying collateral.[10] Rating agencies, however, are private companies.[11] They are not substantively regulated

trol. For a thoughtful analysis of enforcing private tort rights against rating agencies, see Gregory Husisian, Note, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411 (1990). Although Mr. Husisian concludes that the private tort system should not be expanded beyond its limited existing state, his rationale—that such expansion would induce rating agencies to create costly "paper trails" that would not produce a better product—does not necessarily apply with the same force to direct public control.

6. Saskia Sassen, De-Nationalized State Agendas and Privatized Norm-Making 9, 11 (2000) (unpublished manuscript, on file with the *University of Illinois Law Review*) [hereinafter De-Naturalized State Agendas].

7. *See also* Gillian Hadfield, Privatizing Commercial Law: Lessons from the Middle and the Digital Ages 28–31 (Mar. 2000) (unpublished manuscript, on file with *University of Illinois Law Review*) (discussing government reliance on private companies, such as TRUSTe and VeriSign Inc., to maintain guidelines, checkpoints, and a responsive system to handle disputes surrounding Internet privacy and confidentiality issues; arguing that because private firms can develop new practices and adjust to changing environments more quickly than governmental bureaucracy, utilizing the private sector lowers public sector costs and increases the pace of industry expansion); Gillian E. Metzger, Privatization and the Constitution 2–4 (Oct. 13, 2000) (unpublished manuscript, on file with author) (commenting that although "[p]rivatization of government is not new[,] . . . there is evidence of a recent turn towards even greater government privatization, and more importantly an expansion in the breadth of responsibility and discretion being delegated to private actors"). Even social scientists are beginning to study this trend. *See, e.g.*, Ronie Garcia-Johnson, Beyond Corporate Culture: Reputation, Rules, and the Role of Social and Environmental Certification Institutions 9 (Feb. 5, 2001) (unpublished manuscript, on file with *University of Illinois Law Review*) (analyzing private certification institutions, and observing, that "such institutions have been relatively neglected by the social sciences"); *id.* at 3 (citing REPUTATION: STUDIES IN VOLUNTARY ELICITATION OF GOOD CONDUCT (Daniel B. Klein ed., 1997)).

8. *See infra* notes 162–64 and accompanying text.

9. Steven L. Schwarcz, *The Universal Language of Cross-Border Finance*, 8 DUKE J. COMP. & INT'L L. 235, 251–52 (1998) [hereinafter Schwarcz, *Universal Language*].

10. *Id.* Professor Sassen describes this assessment as "a complicated mixture of elements. Credit rating agencies . . . have specialized in this mix of datums and interpretation. This is a strategic good under conditions of globalization where the number of datums and imponderables to be evaluated has grown enormously compared with closed national economies." Sassen, Rating Agencies, *supra* note 2, at 6.

11. Schwarcz, *Universal Language*, *supra* note 9, at 251–52.

by the United States or any other major financial-center-nation.[12] Several of these nations, however, impose a minimal form of governmental control by giving official recognition to rating agencies that meet certain criteria.[13] Often, though, these criteria are vague or informal,[14] and the recognition is for limited purposes only.[15]

This is exemplified by United States law, which contemplates an informal process by which a rating agency can be designated as a nationally recognized statistical rating organization (NRSRO).[16] (Hereinafter the term "NRSRO designation" will be used generically to include any governmental approval of rating agencies, irrespective of the country in which the approval occurs.) If a rating agency is designated as a NRSRO, its ratings can be used to satisfy rating requirements established by government agencies like the Securities and Exchange Commission

12. Several nonfinancial center nations in Latin America (Argentina, Bolivia, Uruguay, Mexico, Paraguay, Chile, and Peru) and East Asia (Malaysia, Korea, and Taiwan) do, however, regulate the ratings industry through structural requirements, such as capitalization thresholds, employee experience and integrity requirements, and through rating methodology directives. *See* GLOBAL INDEX OF THE USES OF RATINGS IN REGULATIONS AND REGULATIONS AFFECTING RATING AGENCIES, 6–17 (Apr. 2000) [hereinafter GLOBAL INDEX]. For example, in Argentina and Chile, regulators require rating agencies to submit rating methodology and criteria to a regulatory body for approval, and have established official bodies that oversee and approve ratings. *See id.* at 6–17 (referring to Decree 656, Private Debt Securities, Public Offering Regulation, Art. 6(h) (Apr. 28, 1992) (Argentina) and Ley No. 18,045, Article 76 (Chile)). Korea regulates entrance procedures for new rating agencies by imposing capitalization and employee qualification requirements. *See* Proposals for Improving Credit Rating System, *at* http://www.mofe.go.kr/ENGLISH/Data/E_POLICY_ISSUE/eb_1010.html (last visited Aug. 21, 2001) (requiring rating agencies to employ at least thirty people, of which at least five must be certified public accountants and at least fifteen must have been educated at the Korea Stock Training Institute or at a professional training school; restricting principal shareholders of a rating agency from holding more than 10% of the agency's value; and limiting the agency's business to credit ratings). Taiwan requires rating agencies to partner with an internationally recognized rating agency, and also imposes standards similar to those in Latin America as well as overseeing agency structure by approving its corporate documents (such as the articles of incorporation and corporate bylaws) and any changes thereto. *See* Rules Governing Administration of Credit Rating Enterprises, Ref. No. Taiwan-(86)-Finance-16981 (Apr. 30, 1997), *at* http://www.selaw-e.com.tw/scripts/tornado/ShowLaw.asp?law=42 (last visited Aug. 21, 2001). India requires that rating agency applications be endorsed by reputable parties in the financial community, and that agencies must renew their applications every three years. It also imposes a net capital worth threshold, limits the agency's business to credit ratings, and requires that no employee be convicted of any transgression involving "moral turpitude or any economic offense." Securities and Exchange Board of India (Credit Rating Agencies) Regulations, S.O.547(E) (1999), *at* http://www.sebi.gov.in/ (last visited Aug. 21, 2001).

13. For example, Japan, France, Hong Kong, and the United States recognize certain rating agencies for specific legal purposes, but do not substantively regulate those agencies. *See* GLOBAL INDEX, *supra* note 12, at 22, 25, 36; *see also* Progress in the Financial System Reform, *at* http://www.mof.go.jp/english/big-bang/ebb34.htm (last visited Aug. 22, 2001) (describing the Japanese approach).

14. *See* Amy K. Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?*, 20 SETON HALL LEGIS. J. 293, 323 (1996).

15. *See, e.g.*, *infra* notes 126–51 and accompanying text (discussing the limited significance of the NRSRO designation in the United States); *see also* CHARLES ADAMS ET AL., INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, PROSPECTS, AND KEY POLICY ISSUES 156–58 (International Monetary Fund survey, Sept. 1999), *available at* http://www.imf.org/external/pubs/ft/icm/1999/index.htm (last visited Aug. 13, 2001) (summarizing the regulatory use of credit ratings in selected countries).

16. Schwarcz, *Universal Language*, *supra* note 9, at 251 n.74. For a description of this process, see Rhodes, *supra* note 14, at 323.

(SEC) in certain federal regulatory schemes. For example, Rule 3a-7 of the Investment Company Act of 1940[17] exempts certain financings from registration and compliance with that Act if, among other requirements, the securities are rated "investment grade" by at least one NRSRO.[18] While there has been debate whether more regulation is necessary, and the SEC itself has called for comments on the NRSRO-designation,[19] some argue that market forces create sufficient checks on rating agencies.[20]

Because government reliance on ratings is swiftly expanding worldwide,[21] this debate is likewise transcending national borders. Most notably, the Basel Committee, the "top global banking regulator,"[22] issued a June 1999 report—*A New Capital Adequacy Framework*[23]—proposing new capital adequacy guidelines for banks. The problem with existing guidelines, under which banks must set aside a percentage of their assets to cover the possibility of default, is that they do not differentiate the default risk of different loans.[24] The new proposal would allow banks, in conjunction with supervisory authorities, to calibrate this risk by using

17. 15 U.S.C. § 80a (2000).

18. *Id*. § 80a-6(a)(5)(A)(iv)(I). For examples of other laws that provide exemptions based on ratings, see 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, 603–08 (1993); ADAMS ET AL., *supra* note 15, at 154–55 (summarizing U.S. regulations that make use of credit ratings); *see also* Bankruptcy Reform Act of 2001, S. 220, 107th Cong. § 912 (2001) (proposing a "true sale" safe harbor for securitization transactions in which at least one class of securities is rated investment grade by an NRSRO when the securities are initially issued).

19. In 1994, the SEC issued a request for comments on the use of the NRSRO designation in the context of Rule 3a-7. *See* Concept Release on Nationally Recognized Statistical Rating Organizations, Exchange Act Release Nos. 33-7085; 34-34616, 59 Fed. Reg. 46,314 (Sept. 7, 1994). More recently, the SEC issued a proposed rule to amend the net capital rule by formally defining the term NRSRO, but no final rule has been issued to date. *See* Proposed Rule on Capital Requirements for Brokers or Dealers, Exchange Act Release No. 34,39457, 62 Fed. Reg. 68,018 (Dec. 30, 1997).

20. *See generally* Rhodes, *supra* note 14, at 316–21; Bottini, *supra* note 18, at 584.

21. *See* ADAMS ET AL., *supra* note 15, at 145 (noting that "[e]xternal credit ratings are increasingly being adopted in regulations worldwide") & 191 (noting that "[w]hile ratings have been employed most extensively by regulatory agencies in the United States, and to a lesser extent in Japan, there has been expanded use of ratings in Latin American and Asian emerging markets [and] the Task Force on the Future of Capital Regulation of the Basel Committee on Banking Supervision has proposed using ratings to help determine sovereign and private sector risk weights in a revision of Basel capital requirements"); *see also Use and Abuse*, *supra* note 3, at 18 ("British regulators use ratings to help decide how much capital securities firms should set aside against their bond holdings. Japan's finance ministry allows only highly rated borrowers to sell bonds to Japanese investors.").

22. Alan Cowell, *An International Banking Panel Proposes Ways to Limit Risk*, N.Y. TIMES, June 4, 1999, at C4. The Basel Committee was established by the central bank Governors of the Group of Ten countries in 1975 and consists of "senior representatives of bank supervisory authorities and central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States." Press Release, Basel Committee on Banking Supervision, Consultative Paper on a New Capital Adequacy Framework, *at* http://www.bis.org/press/p990603.htm (June 3, 1999). The Committee usually meets at the Bank for International Settlements in Basel, Switzerland. *Id*.

23. BASEL COMM. ON BANKING SUPERVISION, A NEW CAPITAL ADEQUACY FRAMEWORK, *at* http://www.bis.org/publ/bcbs50.pdf (June 1999) [hereinafter A NEW CAPITAL ADEQUACY FRAMEWORK].

24. *See* Cowell, *supra* note 22, at C4.

"external credit assessments [i.e., ratings] for determining risk weights."[25] More specifically, with regard to the risk weights applied to claims against sovereign nations, banks, noncentral government public sector entities, securities firms, and corporations, the Basel Committee proposes replacing the existing capital adequacy approach with a system that would use rating agency assessments for determining risk weights.[26] Once approved, the Basel Committee's proposal is likely to be adopted by most of the world's bank regulatory regimes.[27] That would focus even more world attention on the regulatory debate.[28]

This article focuses on the regulatory debate: whether market forces create sufficient checks on rating agencies, or whether more regulation is necessary.[29] Before engaging in this debate, however, it is necessary to define more precisely what rating agencies do.

B. The Role of Rating Agencies

A rating is an assessment of the likelihood of timely payment on securities.[30] Thus, only the creditworthiness of an investment, not its economic desirability to investors, is rated.[31] Pure equity securities therefore are not rated because they have neither a specified maturity date nor a contractually fixed principal amount. Because rating agencies make their rating determinations based primarily on information provided by the issuer of securities, a rating is no more reliable than that information.[32] Ratings thus do not cover the risk of fraud.[33]

Within these constraints, "the significance of a rating depends entirely on the reputation among investors of the particular rating agency."[34] At present, the most respected and trusted agencies are Stan-

25. A NEW CAPITAL ADEQUACY FRAMEWORK, *supra* note 23, at 5.

26. *See id.* at 26–31. Whether this proposal is appropriate is beyond the scope of this article. *Cf.* Howell Jackson, *The Rule of Rating Agencies in the Establishment of Capital Standards for Financial Institutions in a Global Economy*, CAMBRIDGE CENT. FOR CORP. & COM. L., July 7, 2000, at 13.

27. *See Standard & Poor's Respond to the Basel Committee Proposals* 1, *at* http://www.standardandpoors.com/Forum/RatingsCommentaries/Sovereigns/Articles/012000_basel.htm (Jan. 2000) (commenting that the existing 1988 Basel accord on capital adequacy was so adopted).

28. *See id*. at 11.

29. This article does not, however, address nonregulatory issues, such as whether ratings are superior to credit spreads and other rating alternatives as a means of assessing an investment's safety. *Compare* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 658 (1999) (arguing that credit spreads are superior), *with* ADAMS ET AL., *supra* note 15, at 141–43 (arguing that "[r]atings are clearly more stable than market spreads," while both provide the same degree of imperfect foresight). *See also* Jia He et al., *Credit Spread Curves and Credit Ratings*, *at* http://papers.ssrn.com (last visited Nov. 8, 2001).

30. *See* Salomon B. Samson & Gail I. Hessol, *Ultimate Recovery in Ratings: A Conceptual Framework*, STANDARD & POOR'S CREDITWEEK, Nov. 6, 1996, at 25. Although I do not focus on the special case of insurance industry ratings, they have many of the same characteristics described herein. *See* Bottini, *supra* note 18, at 583–84, and articles cited therein at 582 n.14.

31. Schwarcz, *Universal Language*, *supra* note 9, at 253 n.82.

32. *Id.* at 252 n.76.

33. *Id.*

34. *Id.* at 252.

dard & Poor's Ratings Services, Moody's Investors Service, Inc., and Fitch Investors Service, Inc.,[35] all founded in the United States but now having offices and providing ratings to investors worldwide.[36] There are, however, at least thirty-five to forty additional rating agencies operating outside the United States.[37]

Since a company may issue securities with different risk characteristics, rating agencies generally assign ratings to a particular security rather than the company itself.[38] Long and short-term debt have separate rating scales, reflecting the different risks associated with long and short-term investing.[39] Using Standard & Poor's ratings as an example,[40] the highest rating on long-term debt securities is AAA, with ratings descending to AA, then to A, and then to BBB and below.[41] The highest rating on short-term debt securities—such as commercial paper[42]—is A-1, with ratings descending to A-2, A-3 and below.[43] The higher the rating, the lower the rating agency has assessed the credit risk associated with the securities in question.[44] Hence, a company's senior debt securities almost always would be rated higher than the same company's subordinated debt securities.[45] "Ratings below BBB- are deemed non-investment grade, and indicate that full and timely repayment on the securities may be speculative."[46] The term investment grade "was originally used by various regulatory bodies [in the United States] to connote obligations eligible for investment by institutions such as banks, insurance companies

35. On June 1, 2000, Fitch IBCA Investors Service, Inc. and Duff & Phelps, Inc. merged to form Fitch. *See* Sheri Carpenter, *Here's the New Fitch*, BOND BUYER, June 2, 2000, 2000 WL 5812389.

36. Schwarcz, *Universal Language*, *supra* note 9, at 252. Fitch, for example, with headquarters in New York and London, rates entities in seventy-five countries and is wholly owned by the French company, FIMALAC, S.A. *See Company Description*, *at* http://www.fitchibca.com/corporate/offices/fitch_executives.cfm (last visited Jan. 30, 2002); *cf.* Garcia-Johnson, *supra* note 7, at 2 (noting that third-party certification institutions are "emerging at the global level where no coordinating or supervising authority exists, and where multilateral regimes and institutions are difficult to construct").

37. *See* Lawrence J. White, The Credit Rating Industry: An Industrial Organization Analysis 7–8 (Feb. 2001), *available at* http://www.papers.ssrn.com.

38. "Recently, however, some rating agencies . . . have been assigning company ratings that apply to any [generic] issuance of the company's senior unsecured debt securities." Schwarcz, *Universal Language*, *supra* note 9, at 253 n.80.

39. All other factors being equal, long-term investing has greater risk because of the greater uncertainty of predicting future events.

40. Other rating agencies use similar, although not precisely identical, rating nomenclature.

41. Schwarcz, *Universal Language*, *supra* note 9, at 252 n.77. Long-term ratings sometimes include "+" and "-"or other modifying designations associated with the ratings. *Id.*

42. "Commercial paper means short-term debt securities issued by a corporation. 'Typically, only large, quality rated firms issue commercial paper. Issuers like commercial paper because of its maturity, its flexibility and the absence of hard collateral.'" *Id.* at 252 n.78 (citation omitted).

43. *Id.* at 252. "A-1 is the highest short-term rating for Standard & Poor's, P-1 for Moody's, F-1 for Fitch, and D-1 for Duff & Phelps." *Id.* at 252 n.79 (citation omitted).

44. *Id.* at 252–53.

45. *Id.*

46. *Id.* at 253.

and savings and loan associations. Over time, this term gained widespread acceptance throughout the investment community."[47]

Because a high rating signals low credit risk to investors, a company that issues AAA rated securities can more easily attract investors for its securities than can a company that issues AA or BBB rated securities.[48] Therefore, the company with AAA rated securities can pay a lower interest rate on those securities, and still attract investors, than can the company with the lower rated securities. Sometimes an investor may prefer, if it finds the extra risk acceptable, to invest in a BBB rated security, rather than a AAA rated security, in order to benefit from the higher interest rate.[49]

The existence and almost universal acceptance of ratings make it much easier for investors in the capital markets to assess the creditworthiness of a given issuance of securities. In this sense, ratings can be thought of as a public good.[50] Certain rating agencies even "view their ratings as worldwide standards, and not as relative risk standards within countries."[51] Thus, a BBB rating on securities is intended to convey the same level of risk regardless of the jurisdiction in which the securities are issued.[52] This sometimes creates a problem for companies that would otherwise have high ratings, but which are located in countries that have political or financial instabilities because the rating on the company's securities usually is limited by the rating of the country itself.[53] On the other hand, the growing need for ratings has the salutary effect of motivating foreign companies and foreign governments to increase their transparency by providing the type of information needed to support a higher rating.[54]

To a large extent, the almost universal demand by investors for ratings makes rating agencies gatekeepers of the types of securities that investors will purchase.[55] That, however, can slow down experimentation with inventive transaction structures, especially in the innovative fields of

47. STANDARD & POOR'S, CORPORATE RATINGS CRITERIA 9 (2001) [hereinafter RATINGS CRITERIA].

48. Schwarcz, *Universal Language*, *supra* note 9, at 253.

49. *Id.* at 253 n.82.

50. *Cf.* Garcia-Johnson, *supra* note 7, at 5 (arguing that "[t]he provision [by certification institutions] of rules, and records of conformance, can be thought of as a public good that is, in a globalized world, often underprovided").

51. Schwarcz, *Universal Language*, *supra* note 9, at 253 n.84 (referring to the way that Standard & Poor's views its ratings).

52. Interview with Petrina Dawson, Managing Director and Associate General Counsel, Standard & Poor's Ratings Services, in Durham, N.C. (Mar. 11, 1998); *cf.* Garcia-Johnson, *supra* note 7, at 1 (arguing that one of the primary functions of certification institutions is to "make assessments of reputation replicable, more easily transmitted, and much easier to compare").

53. This is sometimes referred to as sovereign ceiling. *See* RATINGS CRITERIA, *supra* note 47, at 37.

54. *See id.* at 6, 30.

55. *See* Schwarcz, *Universal Language*, *supra* note 9, at 253.

structured finance and securitization.[56] This unprecedented power, combined with their de facto control over international debt markets, makes the issue of whether rating agencies should remain unregulated more urgent.[57]

II. ANALYSIS

To analyze this issue, one must first understand the normative rationale for regulation. In an economic context where health and safety are not at issue, regulatory policy generally views this rationale as "foster[ing] improvements judged in efficiency terms."[58] An exception might arise, however, where society has objectives in addition to economic efficiency.[59] Where such other objectives arise, they are principally distributional.[60]

Are there any such other objectives in a rating agency context? This is not merely a rhetorical question; even commercial regulation might have other objectives based on indirect social consequences. Consider, for example, the dispute over the proper goals of bankruptcy reorganization law. Some argue that the only goal of bankruptcy reorganization law should be economic efficiency, while others argue that there are also distributional objectives, such as rehabilitating troubled debtors and ensuring equality of distribution to creditors.[61]

To illustrate the controversy, query whether bankruptcy law should permit a fundamentally bad business to reorganize. Some may advocate reorganization, arguing that bankruptcy law "serves an important purpose in rehabilitating firms that, but for bankruptcy protection, would fail. Jobs would be lost and communities damaged, economically and otherwise."[62] Others, however, would allow reorganization only where it is economically efficient: If a bad restaurant is replaced by a much better

56. *See id*; *see also infra* notes 109–22 and accompanying text (describing securitization and discussing the gate-keeper problem).

57. *See, e.g.*, Reexamining the Regulation of Capital Markets for Debt Securities, Panel IV: Rating Agencies: Substitute or Necessary Corollary to the Regulation of Debt Markets?, *at* http://www.law.duke.edu/globalmark/conf/BMA%20Conference.html (proceedings of Oct. 18–19, 1999 conference held by Duke University's Global Capital Markets Center in Washington, D.C., cosponsored by the Bond Market Foundation, raising this same issue).

58. W. KIP VISCUSI ET AL., ECONOMICS OF REGULATION AND ANTITRUST 9 (3d ed. 2000); *accord* Hadfield, *supra* note 7, at 58 (arguing that the "public value at stake in relationships between commercial entities . . . is economic efficiency").

59. *See* EDITH STOKEY & RICHARD ZECKHAUSER, A PRIMER FOR POLICY ANALYSIS 297 (1978) (arguing that "[t]he rationale for government intervention must be either that in particular areas the market is performing poorly or not at all, or that the society has objectives in addition to economic efficiency").

60. *See id.* (observing that "concern for the distribution of welfare is the principal additional objective").

61. Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 542–43 (1999) (examining this dispute).

62. Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 577 (1998) (illustrating the distributional perspective).

one, employment levels in the city may even increase. Keeping a bad restaurant in business postpones the inevitable and delays a desirable shift of labor and capital to somewhere the inputs can be put to better use.[63] At least one noted bankruptcy scholar believes this dispute is irreconcilable.[64]

One can imagine this same type of dispute over the goals of rating agency regulation—some arguing that such regulation should incorporate distributional objectives because ratings affect a company's ability to raise funds and the cost thereof, which in turn can affect the company's ability to hire and retain employees; others arguing that the only goal should be economic efficiency. There are, however, cogent reasons why the latter view should prevail.

The regulatory scheme most analogous to rating agency regulation—securities law—focuses primarily on the goal of economic efficiency in lieu of distributional objectives.[65] The analogy between these forms of regulation is close because rating agencies perform the same function as securities law: reducing the information asymmetry between issuers of securities and investors.[66] That rating agencies remediate that asymmetry in order to profit, whereas securities law remediates it in order to correct market failure and thereby increase efficiency, is irrelevant—the functions are the same.

Of course, the fact that efficiency *is* the central goal does not necessarily prove that it *should be* that central goal for securities law, and

63. *Id.* at 580 (illustrating the efficiency perspective that firms with inherently bad businesses should be allowed to fail to ensure that their assets are put to the best use).

64. *Id.* at 596–99 (concluding that the dispute "is at bottom normative," and hence "[b]ridging the gap between [the disputants] 'must ultimately dissolve into a study of aesthetics and morals'") (quoting R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 43 (1960)).

65. *See, e.g.*, THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 9 (3d ed. 1996) (observing that efficiency is a central goal of U.S. securities laws); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 751–52 (1984) (arguing that the strongest arguments for the mandatory disclosure system under securities law are based on efficiency, not fairness). Although some have suggested that fairness is also an important goal of securities regulation, fairness might only be relevant in this context as a means of achieving efficiency. *See, e.g., The Bond Price Competition Improvement Act of 1999: Hearing Before the Subcomm. on Fin. & Hazardous Materials of the House Comm. on Commerce*, 106th Cong. 9 (1999) (statement of Hon. Arthur Levitt, Chairman, Securities and Exchange Comm'n) (testifying that "[i]nformed investors, armed with accurate information, ensure that market prices represent fair values. And fair market prices, in turn, ensure that the markets perform their economic function of efficiently allocating capital resources.").

66. *See, e.g.*, JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 70 (1995) (arguing that the primary function of the Securities Act of 1933 is remediation of information asymmetries); MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 1 (2d ed. 1996) ("Undoubtedly, the central focus of the federal securities laws is that of disclosure, thereby providing shareholders and the marketplace with sufficient information to make relevant decisions"); *see also* The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity, *at* http://www.sec.gov/about/whatwedo.shtml (Dec. 1999) (stating that the U.S. Securities and Exchange Commission's function as ensuring that "all investors . . . should have access to certain basic facts about an investment prior to buying it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public, which provides a common pool of knowledge for all investors to use to judge for themselves if a company's securities are a good investment."

hence for rating agency regulation.[67] That result follows, however, because efficiency is also the *normative* goal of securities law: to "develop a global regulatory framework that preserves the efficiencies associated with international capital mobility."[68]

Moreover, if rating agency regulation was based on factors other than economic efficiency, ratings would, to some extent, reflect those other factors. Investors, who typically look for the highest economic return for a given level of safety, then would be misled, undermining their confidence in the rating system and their willingness to invest in rated securities. In theory, of course, those other factors could be disclosed to investors; but even then, investors would find it costly and difficult to try to determine what the rating would have been absent those other factors.

I therefore conclude that improving efficiency should be the rationale for regulating rating agencies.[69] There are two ways that regulation could do this: by rating agencies' performance on the tasks they already do well,[70] or by limiting the negative consequences of their actions.[71] Each is considered in turn.[72]

In making this inquiry, it must be cautioned that regulation itself poses intrinsic costs that can offset any efficiency gain.[73] Even where

67. *See, e.g.*, Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1814–15 (1998) (arguing that, in general, "the appropriate response to an 'ought' claim is an 'ought not' claim, not an 'is' claim").

68. HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE 46 (7th ed. 2000); *accord* GEORGE J. STIGLER, THE CITIZEN AND THE STATE 88 (1975) (arguing that economic efficiency *should be* a central goal of the U.S. securities laws because "efficient capital markets *are* the major protection of investors"); Nathaniel Carden, Comment, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. CHI. L. REV. 879, 882 (1998) ("[t]he concept of efficiency is a normative goal [for securities regulation]: an efficient market is desirable because it ensures that society's productive assets are transferred to those who can make the best use of them, thereby maximizing aggregate welfare"). *But cf.* Saul Levmore, *Efficient Markets and Puzzling Intermediaries,* 70 VA. L. REV. 645, 649–50, 656 (1984) (arguing that market efficiency should not dictate policies concerning government regulation of the market without consideration of practical market effectiveness).

69. That ratings on sovereign debt can affect a State's ability to borrow and the cost thereof should not change this conclusion because market efficiency is desirable even in the sovereign debt context. *Cf.* Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 993, 1009 (2000) (arguing that multinational governmental entities such as the International Monetary Fund should allow the market to work and not act as lenders of last resort to sovereign debtors, even if that means allowing a sovereign nation to default).

70. In theory, regulation could also compel rating agencies to perform other beneficial tasks that they do not presently perform. I am unaware of what those other tasks would be, and there is no literature suggesting that rating agencies should expand their role. I therefore assume in this article that there are no such other tasks.

71. *Cf.* Peter P. Swire, *Markets, Self-Regulation, and Government Enforcement in the Protection of Personal Information* 14, *available at* http://www.ntia.doc.gov/reports/privacy/selfreg1.htm (Oct. 3, 2001) (arguing that government regulation may be appropriate where self-regulation causes externalities).

72. Rather than focusing on types of additional regulation, my analysis focuses on whether the ratings system is broken or can be made to work better. If not, it need not be fixed, irrespective of the types of remedial regulation.

73. *See, e.g.*, JOHN EATWELL & LANCE TAYLOR, GLOBAL FINANCE AT RISK 19 (2000) ("[R]egulation can be expensive and oppressive or even downright wrongheaded. Overly fastidious regulation may result in risks being overpriced, and hence will stifle enterprise. . . . A balance needs to

there is market failure, "government intervention may not [always] yield a superior outcome."[74] I therefore attempt to offset the costs of regulation against any potential gains.

A. Regulation to Improve Performance

As the prior discussion has shown, rating agencies improve the efficiency of securities markets by acting as informational intermediaries between issuers and investors in order to increase the transparency of securities and thereby reduce the information asymmetry. This is especially valuable where individual investors face high costs relative to their investment in assessing the creditworthiness of an issuer's securities. A relatively small number of rating agencies can make this assessment on behalf of many individual investors, thereby achieving an economy of scale. Government regulation could increase this efficiency only by reducing overall costs or by improving ratings reliability.

Presently, there is little reason to believe that rating agency costs are excessive. The fee charged by a rating agency typically is market-driven and varies according to the size and complexity of the transaction being rated.[75] At least for public transactions, the fee also covers ongoing monitoring of the rating.[76] From the standpoint of the rating agencies themselves, these fees reflect, among other things, the costs of the large staff of experienced analysts needed to assess ratings[77] and the risk that the rating agency will be sued based on a rating that, in retrospect, might appear unjustified.[78] Even if rating agency costs were considered exces-

be struck . . . ."); *see also* Bottini, *supra* note 18, at 610–11 (observing that "[t]oo much regulation inhibits economic growth by increasing costs and making capital harder to raise").

74. VISCUSI ET AL., *supra* note 58, at 10; *see also id.* at 13 (observing that "'government failure' may be of the same order of importance as market failure"); *accord* STOKEY & ZECKHAUSER, *supra* note 59, at 309–10 (warning that "the history of [government] interventions to deal with market failure is a history of disappointments [and hence one] should recognize that market failure does not mandate government intervention; it just suggests the possibility that such intervention might prove beneficial").

75. Letter from Leo C. O'Neill, President, Standard & Poor's Ratings Services, to Jonathan Katz, Secretary, Sec. & Exch. Comm'n 9–10 (Feb. 27, 1998) (on file with author).

76. *Id.* at 10.

77. Rating agencies employ expert analysts who examine and scrutinize public and private information about a company to determine its long term ability and willingness to meet its debt obligations. *See* Moody's Investors Service, *A "Universal" Approach to Credit Analysis*, *at* http://www.moodys.com/moodys/mdyappr.htm (last visited July 26, 2000). Professors Gordon and Kornhauser argue that this approach is a more cost effective way than analysis by individual investors. *See* Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information and Securities Research*, 60 N.Y.U. L. REV. 761, 817 (1985).

78. *See, e.g.*, County of Orange v. McGraw-Hill Cos., No. SA CV 96-0765-GLT, 1997 U.S. Dist. LEXIS 22459 (C.D. Cal. June 2, 1997) (denying Standard & Poor's motion to dismiss lawsuit arising from its investment grade rating of Orange County's bonds, which later defaulted); LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co., 951 F. Supp. 1071 (S.D.N.Y. 1996) (stating that rating agencies motion to dismiss lawsuit arises from a future to downgrade bond rating despite bond programs noncompliance with indenture agreements). Nonetheless, rating agencies in the United States are generally held to a recklessness, not a simple negligence, standard and have rarely been found liable. *See* First Equity Corp. v. Standard & Poor's Corp., 869 F.2d 175, 180 (2d Cir. 1989) (rating agency not li-

sive, however, government regulation rarely reduces costs and includes costs of its own, such as the public sector need to administer the regulation and the private sector need to retain counsel to advise on compliance with the regulation.[79]

Likewise, there is little reason to believe that increased regulation will improve the reliability of ratings. Rating agencies have had a remarkable track record of success in their ratings,[80] and recent rating experience is even more reliable:

> In 20 years only one company with an investment-grade rating from Moody's has defaulted on long-term debt—Manville, a single-A company that went bankrupt voluntarily to protect itself from asbestosis lawsuits. A New Zealand finance company, DFC, defaulted on its commercial paper in 1989 while still carrying a prime rating by S&P. The agency says it relied on a government commitment to provide liquidity, but the government reneged.[81]

Because most studies only appear to take into account defaults on debt that is highly rated at the time of default, they do not necessarily address ratings stability. However, a recent internal analysis by Standard & Poor's, using information extracted from its proprietary database on 9,169 companies with rated debt, confirms the stability of investment

able for rating that included incorrect description of accrued interest payable upon conversion of debt instruments); *In re* Republic Nat'l Life Ins. Co., 387 F. Supp. 902, 905 (S.D.N.Y. 1975) (rating agency has no duty to verify collected statistics used in rating process). For an analysis of whether credit rating agencies should be held to a stricter standard of liability, see Husisian, *supra* note 5, at 427. Husisian concludes that "an expansion of rating agency liability would impose significant costs on rating agencies without significantly increasing rating agency accuracy." *Id.* at 460.

79. *See, e.g.*, Swire, *supra* note 71, at 7–9 (arguing that even if public officials act perfectly for the public good, regulation will give rise to bureaucratic administrative costs and industry compliance costs, as well as costs arising from the fact that regulatory rules are inflexible and inherently imperfect; and that, moreover, public choice theory shows that public officials do not always act perfectly for the public good). Thus, a recent study by the National Telecommunications and Information Administration comparing market, government, and self-regulation to determine the most effective way of protecting consumer privacy included, as limitations on government regulation, "the expense to the government of drafting the privacy rules, administering the rules and enforcing the rules in particular cases. . . . The amount of funding can clearly be substantial." *See id.* at 2, 7; *see also* POSNER, *supra* note 5, § 13.1, at 369.

80. *See, e.g.*, W. BRADDOCK HICKMAN, NAT'L BUR. ECON. RESEARCH, CORPORATE BOND QUALITY AND INVESTOR EXPERIENCE (1958) (finding, among other things, that top-rated (i.e., Moody's AAA and equivalent for other rating agencies) corporate debt had a default rate of 5.9%, whereas lowest investment grade-rated corporate debt (i.e., Moody's BAA and equivalent for other rating agencies) had a default rate of 19.1% and noninvestment grade rated corporate debt (i.e., Moody's Ba and below and equivalent for other rating agencies) had a default rate of over 40%, in each case during the period 1900–43).

81. *Credit-Rating Agencies: Beyond the Second Opinion*, ECONOMIST, Mar. 30, 1991, at 80. This latter default reflects the view that rating agencies are less accurate in rating country debt, ascribed to "political factors mak[ing] forecasting much more hazardous" and the "alarming tendency [of countries] to default on their obligations." *Room for Improvement: Rating Agencies*, ECONOMIST, July 15, 1995, at 54. Investors, however, compensate for this reduced accuracy; when "pricing government issues," they "consistently demand[] higher yields than the ratings would imply." *Id.*; *accord* ADAMS ET AL., *supra* note 15, at 137–39 (finding that for corporate securities, "ratings, on average, are a good indicator of relative creditworthiness," but that "[e]valuating the performance ratings in the sovereign sector is more problematic than for corporates").

grade ratings, finding, for example, that "all 'A' rated companies at the beginning of a given year would have an 87.94% chance of maintaining that same rating by year end."[82]

The reliability of ratings can be explained by reputational costs: the profitability of rating agencies is directly dependent on their reputations.[83] Inaccurate ratings will impair, if not destroy, a rating agency's reputation:

> Even more than accountants and lawyers, [rating agencies] must trade on their reputations. If bond investors lose faith in the integrity of rating agencies' judgments, they will no longer pay attention to their ratings; if agencies' opinions cease to affect the price that borrowers pay for capital, companies and governments will not pay their fees. So market forces should make rating agencies careful of their good names.[84]

Thus, rating agencies should want to continue to provide accurate ratings,[85] whether or not there is regulation.[86] Regulation, on the other hand, could impair the reliability of ratings by increasing the potential for political manipulation,[87] and by diminishing the importance of reputational costs as would occur, for example, if regulation were based on considerations other than ultimate ratings reliability.

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82. Leo Brand & Reza Bahar, *Corporate Defaults: Will Things Get Worse Before They Get Better*, STANDARD & POOR'S CREDITWEEK, Jan. 31, 2001, at 15, 23, 27, *available at* http://www.standardpoor.com/Forum/RatingsCommentaries/StructuredFinance/Articles/12901_corporatedefaults.html (setting forth a table of average one-year transition rates showing for each initial rating from AAA down to CCC the likelihood that the rating will change during a year); *accord* ADAMS ET AL., *supra* note 15, at 203 (noting that "ratings have been relatively stable").

83. *See Credit-Rating Agencies. AAArgh!*, ECONOMIST, Apr. 6, 1996, at 80 [hereinafter *AAArgh!*] (observing that Moody's, "[l]ike all credit-rating agencies, . . . depends for its livelihood on its reputation among investors for objectivity and accuracy").

84. *Use and Abuse*, *supra* note 3, at 18.

85. Indeed in the aftermath of some recent criticism that they were too slow in identifying the problems at Enron Corp., the leading rating agencies announced they would consider "changing the way they determine their ratings to make them more timely." Riva D. Atlas, *S.& P. and Moody's Weigh Changes in Light of Enron*, N.Y. TIMES, Jan. 22, 2002, at C6.

86. *But cf.* Jackson, *supra* note 26, at 13 (arguing that the use of ratings for determining capital adequacy, proposed by the Basel Committee, may place increasing pressure on rating agencies to give favorable ratings). Some workshop participants also suggested that rating agencies sometimes might assign suboptimal ratings where the appropriate rating falls between categories, such as between BBB (investment grade) and BB (noninvestment grade). Behavioral psychology then might predict systematic underrating, as illustrated by the alleged tendency of weather forecasters to predict rain rather than sun in marginal cases because few complain when a forecasted rainy day turns out to be sunny. Ratings also might be a self-fulfilling prophecy in marginal cases, such as where an investment grade rating allows a company to raise funds and survive whereas the same company, faced with a noninvestment grade rating, would lack liquidity and fail. Even if these suboptimalities sometimes do occur, however, government regulation would not appear to avoid them.

87. *See, e.g.*, Memorandum from Kenneth C. Kettering, Partner, Reed Smith Shaw & McClay LLP (now Associate Professor, New York Law School) 2 (July 6, 2000) (on file with *University of Illinois Law Review*) (arguing that "[o]ne serious drawback to government regulation . . . is the potential for political manipulation. . . . The services provided by rating agencies are . . . very largely subjective, and it is hard to see how anyone could tell whether particular ratings are biased.").

Consequently, government regulation would neither reduce costs nor improve reliability. I therefore turn to the question of whether regulation would limit the negative consequences of rating agency actions.

B. Regulation to Limit Negative Consequences

There are various negatives associated with rating agency actions. First is the perception—related to a central question of private ordering, the extent to which it undercuts democratic authority[88]—that rating agencies are not accountable because they are not officially subject to public scrutiny. This would be problematic if, as a result, rating agencies misbehaved or issued inaccurate ratings. As the foregoing discussion has shown, however, the lack of official public scrutiny does not appear to affect ratings accuracy because of the de facto accountability of rating agencies through reputation.[89] Whereas government officials may derive the appearance of accountability through an electoral process, their ability to be elected is similarly driven by reputation. To this extent, reputational constraints can be viewed as a normative complement to the democratic process.[90]

A second potential negative is the conflict of interest inherent in the way that rating agencies are paid. Rating agencies are virtually always paid their fee by the issuer of securities applying for the rating.[91] This raises the possibility that the issuer will use, or the rating agency will perceive, monetary pressure to improve the rating. Nonetheless, there appears to be little alternative to this arrangement because of the collective action problem in coordinating potential investors to pay this fee. One rarely can know in advance which investors will purchase a given issu-

88. *See, e.g.*, A. Michael Froomkin, *Wrong Turn in Cyberspace: Using ICANN to Route Around the APA and the Constitution*, 50 DUKE L.J. 17, 168 (2000) (arguing that using a private company, the Internet Corporation for Assigned Names and Numbers, to manage Internet infrastructure has a "pernicious effect . . . on our democracy"); Robert O. Keohane & Joseph S. Nye, Jr., Between Centralization and Fragmentation: The Club Model of Multilateral Cooperation and Problems of Democratic Legitimacy (Feb. 2001) (unpublished manuscript) (on file with author), *available at* http://papers.ssrn.com (focusing on the challenges to the legitimacy of the World Trade Organization posed by democratic theory).

89. *Cf. infra* notes 107–09 and accompanying text (discussing unsolicited ratings).

90. *Cf.* Keohane & Nye, *supra* note 88, at 12–14 (noting that democratic "accountability is not assured only through elections," and giving examples of "non-electoral accountability"). Reputation cannot, however, be a complete *substitute* for democratic accountability in our context because a rating agency's reputation is limited to issuers of and investors in securities. Reputation thus drives only accountability to such issuers and investors, not to a state's entire populace.

91. *See AAArgh!*, *supra* note 83, at 80 (observing that "[n]ormally issuers invite, and pay, the agencies to rate their debt"). One reviewer of this article has "always suspected that the evolution of the issuer-pay model was basically driven by the rating agencies' agendas: it's easier to extract money from issuers than from investors, and selling the information to investors would raise the threshold of responsibility that the rating agencies would have to investors misled by bum ratings." Memorandum from Kenneth C. Kettering, *supra* note 87, at 1. As argued below, however, this model may also be driven by collective action considerations.

ance of securities,[92] and even if one did, it would be difficult to persuade those investors to pay their pro rata portion of the rating agency fee directly.[93] The issuer therefore may be the only party realistically capable of paying the rating agency's fee in all situations.[94] This does not, however, eliminate the potential conflict of interest that an issuer might be tempted to use the fee to strategically bargain for a higher rating.

In theory, a regulation could require investors to pay this fee, or could require an issuer to pay the fee irrespective of the rating ultimately assigned. Regulation, however, is costly, and issuers already are customarily required to pay rating agency fees regardless of the rating ultimately assigned.[95] The amount of the fee is also independent of the rating.[96] Coupling this with the fact that reputational costs help to ensure the objectivity and independence of the ratings decision,[97] the aforesaid conflict of interest does not appear to cause any negative consequences.[98] There is, however, one possible exception.

One rating agency, Moody's, has allegedly misbehaved by issuing artificially low unsolicited ratings in private transactions.[99] Critics argue that the conflict of interest described above motivates Moody's behavior:

> [M]oody's rivals [argue that] [a]gencies earn their keep by charging fees to those who issue bonds, not to the investors who use the ratings. This, they claim, can create perverse incentives. By giving borrowers a low, unsolicited rating, the big agencies may force un-

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92. In a public offering, for example, investors bid to purchase the securities only after the securities are offered for sale. *See generally* Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1509 (S.D.N.Y. 1989).

93. Professor Jackson observes that, in a perfect market, investors would be indirectly paying this fee through the pricing on the securities. Interview with Howell E. Jackson, Professor of Law, Harvard University, in Cambridge, Eng. (July 7, 2000). That does not, however, eliminate the potential conflict of interest. Markets are not perfect, and the issuer's control over paying the fee might tempt it to strategically bargain for a higher rating.

94. Historically, rating agencies had sold subscriptions to their ratings to investors, much like wine experts today (such as Robert Parker with *The Wine Advocate* or Stephen Tanzer with his *International Wine Cellar*) sell subscriptions to their wine rating magazines. *See* ADAMS ET AL., *supra* note 15, at 192; Partnoy, *supra* note 29, at 640. Whether or not a similar approach would generate sufficient income to support the large research staffs needed today by rating agencies, and whether on-line computerized delivery would allow rating information to be sent to investors worldwide on a timely basis, are questions that are beyond this article's scope.

95. Rating agencies base their fees mainly on the size and type of the security issuance. *See* Richard Cantor & Frank Packer, *The Credit Rating Industry*, FED. RESERVE BANK N.Y. Q. REV., June 22, 1994, at 4.

96. *Id.*

97. *See supra* notes 86–89 and accompanying text.

98. *See* ADAMS ET AL., *supra* note 15, at 193 (although "[s]ome market participants have argued that charging issuers for their ratings could offer the agencies an incentive to assign higher ratings than warranted by fundamentals," this study concludes that "[g]iven the overriding incentive for the agencies to maintain their credibility, it seems unlikely that they would trade off their credibility in return for short-term revenue gains.").

99. *See AAArgh!*, *supra* note 83, at 80. This is also referred to as rating without request.

willing issuers to pay for their services in the hope of getting a better one.[100]

It is unclear, however, whether unsolicited rating actually constitutes an abuse since suspicion alone drives the conclusion that such ratings are in fact artificially low.[101] Furthermore, the only court to have considered this question refused to impose liability on Moody's.[102] The court's rationale depended on the protection afforded to public opinions by the First Amendment's mandate that Congress shall make no law abridging freedom of speech or of the press—a protection not always available outside of the United States.[103] On the other hand, there is concern that an unsolicited rating may be based on incomplete information about the issuer.[104]

Even if unsolicited rating does constitute an abuse, its scope is limited. It therefore may not justify implementation of a broad regulatory scheme. Instead, targeted remedies, such as requiring disclosure of the fact that a rating is unsolicited, would appear more appropriate. Recently, in fact, Moody's voluntarily instituted such disclosure for certain unsolicited ratings, in "recogni[tion] that market participants have shown an interest in knowing which ratings lack the issuer's participation" and to "help to dispel misconceptions, and increase the credibility and utility of [its] ratings in the capital markets."[105] Reputational costs alone there-

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100. *Id.*; *accord* Bottini, *supra* note 18, at 598–600; *Now It's Moody's Turn for a Review*, BUS. WK., Apr. 8, 1996, at 116; Anne Schwimmer, *How Far Is Too Far?*, INVESTMENT DEALERS' DIG., Feb. 12, 1996, at 14. Moody's, however, contends that unsolicited ratings are "the market's best defense against rating shopping (which occurs when issuers shop among various rating agencies for the highest ratings and seek to suppress lower conclusions). Under such circumstances, rating agencies risk the moral hazard of competing to provide the highest rating in order to obtain the issuer's business." MOODY'S INVESTORS SERV., DESIGNATION OF UNSOLICITED RATINGS IN WHICH THE ISSUER HAS NOT PARTICIPATED 3 (Nov. 1999) [hereinafter MOODY'S INVESTORS SERV.].

101. *Use and Abuse*, *supra* note 3, at 18.

102. In *Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc.*, 988 F. Supp. 1341 (D. Colo. 1997), *aff'd*, 175 F.3d 848 (10th Cir. 1999), Moody's issued a statement "that, although it had not been asked to rate" the bonds in question, the outlook on the issuer's debt was negative and Moody's "intended to assign a rating to the issue subsequent to the [bond] sale." 988 F. Supp. at 1343. At the time of its statement, however, Moody's financial information on the issuer was over a year old. *Id.* The statement caused the bond sale to fail, and the issuer was "forced to reprice its bonds at a higher interest rate in order" to sell them. *Id.* at 1344. The court refused the issuer's demand for damages, reasoning that the unsolicited rating was "a mere expression of opinion protected by the First Amendment." *Id.* at 1347. (Indeed, the appeals court clarified that this unsolicited rating, even if retaliatory, would be protected speech under the applicable state law. *See Jefferson County Sch. Dist.*, 175 F.3d at 858.) The court also refused to allow the issuer to amend its complaint to add antitrust claims, reasoning that First Amendment protected speech cannot be the basis for antitrust liability. *Jefferson County Sch. Dist.*, 988 F. Supp. at 1347–48.

103. For a discussion of these First Amendment issues, see Bottini, *supra* note 18, at 616–19.

104. *See* Cantor & Packer, *supra* note 95, at 19 (observing that issuers want the rating agencies to have complete information to ensure the most accurate and favorable rating possible). For example, in the Jefferson County School District case discussed above, Moody's financial information on the issuer was over a year old. *See Jefferson City Sch. Dist.*, 988 F. Supp. at 1343. *But cf.* MOODY'S INVESTORS SERV., *supra* note 100, at 3 (in which Moody's maintains that it does not assign ratings where it lacks "sufficient information to form a useful conclusion").

105. MOODY'S INVESTORS SERV., *supra* note 100, at 3. Moody's agreed to identify in initial rating assignments those unsolicited ratings for which the issuer has declined to participate, by including the

fore have been sufficient, even in this context, to help correct rating agency misbehavior.[106]

The final negative is that the rating agency system, as presently constituted, is conservatively biased against innovation.[107] This is because the negative reputational consequences of providing a rating that, in retrospect, turns out to be incorrect far outweigh the fee a rating agency can charge for providing that rating. The bias is particularly pronounced in the developing area of securitization, where the securities being rated arise out of complex and innovative transaction patterns. Securitization is "by far the most rapidly growing segment of the U.S. credit markets,"[108] and its "use is rapidly expanding worldwide."[109]

In a typical transaction, a company, usually called the "originator," transfers rights to payment from income-producing assets such as accounts receivable, loans, or lease rentals (collectively, "receivables"), or frequently undivided interests in such rights,[110] to a special purpose vehicle, or "SPV." The SPV, in turn, issues securities to capital market inves-

following statement in the rating assignment press release: ***"This rating was initiated by Moody's. The issuer did not participate in the assignment process."*** *Id.* at 1.

106. One workshop participant queried whether reputation alone would always be sufficient to deter rating agencies from rating too low in order to extract a fee, and suggested that rating agencies be penalized for egregious error. Although some might argue that this type of penalty already exists in limited form, at least in the United States, through the tort system (*cf.* Husisian, *supra* note 5, at 460–61), the only court to have considered this issue refused to impose liability. *See Jefferson County Sch. Dist.*, 988 F. Supp. at 1348.

107. *See supra* note 86 and accompanying text. One commentator has argued, however, that there may be other negatives associated with rating agency action. *See* Bottini, *supra* note 18, at 580–83. The most significant, he believes, is that rating agencies are "too slow to downgrade a rating." *See id.* at 585. His evidence for this, however, is limited to three ambiguous anecdotal examples during an almost twenty-year period. *See id.* at 585–88. He also argues that "rating agencies have . . . been accused of influencing and being influenced by politicians." *Id.* at 595. As for the former charge (influencing), his critique is not that rating agencies have used improper influence but that they "often make suggestions to state legislators concerning ways to improve their [state's] rating." *Id.* at 597. He does not, however, indicate whether any states have in fact changed their operations based on these suggestions, nor does he say whether any of these suggestions have been ill advised. *Id.* at 597–98. Regarding the latter charge (being influenced), he cites only two anecdotal examples; both, however, could be explained by imperfect judgment calls as easily as influence. *Id.* at 595–97. Finally, although he argues that "the rating agencies have been criticized for being inaccurate and for failing to provide adequate disclosure of important financial information to investors who rely on the ratings," he admits that "[o]n the other hand, many claim that the ratings are accurate." *Id.* at 600, 602; *cf. supra* notes 82–86 (listing authorities supporting the accuracy of ratings). Even if these concerns were valid, however, he concludes that "[r]egulation of the entire [rating agency] industry is undesirable" and that all that is "needed is limited regulation directed at the few serious problems afflicting rating agency activity." Bottini, *supra* note 18, at 610–11.

108. Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 24 (1996).

109. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L., BUS. & FIN. 133, 133 (1994) [hereinafter Schwarcz, *Alchemy*]; *see also* Memorandum from William F. Kroener III, General Counsel, James L. Sexton, Director, Division of Supervision, & Mitchell Glassman, Director, Division of Resolutions and Receiverships, Federal Deposit Insurance Corporation (FDIC) to the FDIC's Board of Directors 3 (July 26, 2000) (on file with author) (noting that "asset-securitization has developed into one of the most significant funding sources for American and international corporations").

110. 1 SECURITIZATION OF FINANCIAL ASSETS § 3.09, at 3-52–3-53 (Jason H. P. Kravitt ed., 2d ed. 1999 & 2000-1 Supp.) [hereinafter SECURITIZATION OF FINANCIAL ASSETS] (articulating the advantages of the undivided interest structure).

tors[111] and uses the issuance proceeds to pay for the receivables. The investors, who are repaid from collections of the receivables, buy the securities based on their assessments of the value of the receivables.[112]

The most critical analysis in a securitization is whether the SPV and its investors will continue to be repaid in the event of the originator's bankruptcy.[113] If the SPV has ownership of the receivables, the SPV and its investors will continue to be repaid; if not, their right to be repaid will be suspended and subject to possible impairment.[114] The SPV will gain ownership of the receivables only if the transfer of those receivables from the originator to the SPV constitutes a sale under applicable bankruptcy law.[115] This is usually referred to as a "true sale."

The inherent gate-keeping bias toward market conservatism arises largely out of conservative rating agency views on what constitutes a true sale. For example, irrespective of the legal criteria governing a true sale,[116] some rating agencies remain skeptical whether an SPV that purports to purchase only an undivided interest in, as opposed to whole, receivables is able to gain ownership of the interest purchased.[117] This makes it more difficult to maximize the statistical diversification of the receivables sold to the SPV, and increases the transaction costs of making purchases.[118] The same conservatism also makes rating agencies reluctant to rate innovative new securitization structures, even where the innovation promises to increase efficiency and reduce transaction costs.[119] Without a rating, however, an SPV will be unable to issue its securities.[120]

111. The term "capital markets" refers to any market where debt, equity, or other securities are or may be traded. Capital markets can be formal or informal. *See* JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 59 (3d ed. 1991).

112. *See* Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 STAN. L. REV. 1, 6 (1999); *see also id.* at 6 n.21 (citing basic sources on securitization).

113. *See* Schwarcz, *Alchemy*, *supra* note 108, at 151.

114. *See* STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 29–39 (2d ed. 1993) [hereinafter STRUCTURED FINANCE]. Thus, in cases where the SPV owns the receivables, the investment decisions often can be made without concern for the originator's financial condition. *See id.* at 6.

115. *See* Schwarcz, *Alchemy*, *supra* note 109, at 135.

116. For a discussion of those criteria, see SCHWARCZ, STRUCTURED FINANCE, *supra* note 114, at 28–35.

117. Interview with Eric P. Marcus, Partner and Chair, Structured Finance and Asset-Based Transactions, Kaye, Scholer, Fierman, Hays & Handler, in New York, N.Y. (May 8, 2000).

118. For these reasons, undivided interests are widely used in collateralized loan obligation and bank credit card securitizations. Interview with Henry Morriello, Partner, Structured Finance and Asset-Based Transactions group of Kaye, Scholer, Fierman, Hays & Handler, in New York, N.Y. (May 8, 2000); *see also* SECURITIZATION OF FINANCIAL ASSETS, *supra* note 110, § 3.03[A], at 3-13 (noting that the advantage of the undivided interest structure when securitizing pools of medium term receivables is "that one may avoid the transaction costs associated with numerous separate purchases"); at 3-14 (observing that "mortgage-backed securitizations are generally handled using the [undivided interest] structure"); at 3-14–16 (observing that securitization of credit card receivables also generally uses the undivided interest structure); and at 3-17 (observing that "[t]he most practicable structure [for securitization of trade receivables] has been the purchase of an undivided, fractional interest in a pool of receivables").

119. *See, e.g.*, *Alchemy*, *supra* note 109, at 145 nn.42, 152 (suggesting that rating agencies are uncomfortable rating innovative new securitization structures, such as the divisible interest structure de-

Although this bias may be problematic, it is hard to see how government regulation could reduce it. To the contrary, even the limited form of government regulation represented by the NRSRO-designation increases this bias by restricting the number of approved rating agencies, therefore discouraging competition and hindering the start up of new agencies that do not have national recognition.[121] Rating agencies that have fewer competitive pressures will have less motivation to be innovative and also might charge higher fees.[122] If anything, this suggests that government should consider balancing the need for a rigorous standard for NRSRO designation against the need to ensure that a sufficient number of rating agencies receive NRSRO designation to assure competition.

In summary, regulation would neither limit the negative consequences of rating agency action nor improve rating agency performance. Consequently there is little theoretical justification for such regulation. As discussed, however, States that make the applicability of their laws turn on a rating often utilize NRSRO designation as a minimal form of regulation.[123] Whether the applicability of law should turn on a rating is beyond this article's scope. Nonetheless, so long as the applicability of law does turn on ratings, some form of regulatory approval of rating agencies would appear appropriate. In this context, the next section examines the appropriateness of NRSRO designation as a regulatory methodology.

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scribed therein, absent "case law directly on point," notwithstanding that the divisible interest structure would "permit middle market companies and hospitals to pool their receivables in ways that reduce transaction costs and make securitization far more feasible and attractive").

120. The SPV might, however, be able to issue securities in limited private placements. *Id.* at 145 n.42. One reviewer of this article asked if the conservative bias is a failure or just things working as they should. It is, I believe, a failure because, absent the need for a rating, investors would independently analyze innovative new structures; whereas if those structures are not rated, investors have no incentive, outside of the aforesaid limited private placements, to engage in such analysis.

121. *See* Cantor & Packer, *supra* note 95, at 8 (observing that "[g]iven the growing importance of NRSRO status, new entrants in the ratings business who lack this status may find it increasingly difficult to attract a wide following in the investment community."); *cf.* Garcia-Johnson, *supra* note 7, at 19 (arguing that whereas "certification institutions themselves must be trusted, and must develop a reputation for honesty[,] [t]his is a difficult task, especially for new institutions"). Another regulatory approach might be to require greater transparency of the criteria that rating agencies apply in assigning their credit ratings, but this would be redundant. Issuers already are able to discuss these criteria with rating agency analysts, and the major rating agencies already publish these criteria on their websites. *See Ratings Criteria*, *at* http://www.standardpoor.com/ResourceCenter/index.htm (last visited Sept. 28, 2001) (setting forth Standard & Poor's ratings criteria); *Rating Methodologies*, *at* http://www.moodys.com/moodys/cust/staticcontent/2000200000265724.asp?section=about&topic=method) (last visited Sept. 28, 2001) (setting forth Moody's ratings criteria); *see also* HUGH G. SHERWOOD, HOW CORPORATE AND MUNICIPAL DEBT IS RATED: AN INSIDE LOOK AT STANDARD & POOR'S RATING SYSTEM (1976).

122. *See* POSNER, *supra* note 5, § 9.3, at 280 (arguing that competition may be an incentive to innovation); F. M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE chs. 15–16 (3d ed. 1990) (same); *see also AAArgh!*, *supra* note 83, at 80 (recounting investor perception that Moody's and Standard & Poor's "both have improved their services since they started to face serious competition").

123. *See supra* notes 13–18 and accompanying text.

C. NRSRO Approach to Regulation

As shown above, regulation is not generally needed to improve rating agency efficiency.[124] And, indeed, the purpose of NRSRO designation does not appear to be to improve efficiency per se. Such designation in fact has another purpose: to ensure that where the applicability of specific laws turns on a rating, the issuer of the rating—and thus the rating itself—is a reliable indicator of whether or not to apply those laws.

This suggests that NRSRO designation must be analyzed in the context of those specific laws. The analysis is simplified, however, by the fact that there appears to be only one category of laws whose applicability turns, or should turn, on a rating: securities laws.[125] This intuitively follows because the purpose of ratings is to assess the risks associated with the payment of securities.[126] This conceptually follows because rating agencies perform the same function as securities law—reducing the information asymmetry between securities issuers and investors.[127] Therefore, NRSRO designation is a component of securities law and should be analyzed in that context.

NRSRO designation at first appears to be a theoretically unusual approach to securities law. In the United States, for example, the historical debate regarding enactment of securities laws focused on whether those laws should provide for full disclosure or, instead, governmental merit analysis. State "blue sky" laws provided for the latter.[128] Unlike these state laws, however, the consensus was that federal securities laws should not "establish a system of merit regulation."[129] The rationale was that "investors' ability to make their own evaluations of available investments [through the federal regulatory framework of full disclosure] obviates any need that some observers may perceive for the more costly and time-consuming governmental merit analysis of the securities being offered."[130]

However, NRSRO designation constitutes an indirect form of merit regulation. This is because the designation itself, which controls whether or not securities law exemptions become available, is based on governmental merit analysis of the rating agencies. Nonetheless, this form of merit analysis may be superior to full disclosure. The historical rationale for full disclosure—that investors' ability to make their own evaluations of available investments obviates the need for costly and time-consuming merit analysis[131]—is not always applicable. In the case of evolving and

124. *See supra* Parts II.A–B.
125. *See, e.g.*, *supra* notes 17–18 and accompanying text (discussing securities laws exemptions based on NRSRO-designation).
126. *See supra* note 30 and accompanying text.
127. *See supra* note 66 and accompanying text.
128. HAZEN, *supra* note 65, at 6.
129. *See id.* at 7.
130. *Id.*
131. *See infra* note 132 and accompanying text.

complex debt structures, for example, the cost of each investor individually evaluating his or her investment would be excessive. Rating agency evaluation, in contrast, provides an economy of scale.[132] Furthermore, at least as presently performed, the minimal merit analysis needed for NRSRO designation is neither costly nor time-consuming.[133] Thus NRSRO designation, even though a form of merit regulation, may well be appropriate.

This view is supported by commercial law theory. In contrast to the traditional approach of the past two centuries (referred to as transactional regulation) in which "public agencies have assumed responsibility for the oversight and direct regulation of the conduct of . . . private parties,"[134] a system of commercial law only should require the State to establish the "minimal structure necessary to create private institutions that will then operate under market incentives" to allocate public resources[135] (an approach known as organizational regulation[136]). The rationale for favoring organizational over transactional regulation is derived from actual experience. Organizational regulation produces "rules that are optimal in light of the costs of the rules"[137] because it relies on simple commitment mechanisms, such as reputation.[138] Transactional regulation, however, "does a particularly poor job of achieving optimal legal complexity"[139] because protecting the legitimacy of the State, not efficiency,[140]

132. *See supra* Part II.A. Ratings thus would be viewed as a de facto substitute for full disclosure to the extent that investors rely on ratings in lieu of disclosed information. Whether this shift in reliance is justified, however, is beyond the scope of this article. *Cf.* Revisions to Rules Regulating Money Market Funds, Investment Company Act of 1940 Release Nos. 33-6882; 56 Fed. Reg. 8113, 8115 (Feb. 27, 1991) (indicating that investors should not use ratings as a substitute for making informed judgments based on disclosure); Thomas P. Peacock, *A Review of Municipal Securities and Their Status Under the Federal Securities Laws as Amended by the Securities Act Amendments of 1975*, 31 BUS. LAW. 2037, 2040 n.22 (1976) (arguing that due to the lack of information available to investors, "ratings have doubtless played too important a role in investors' decision making process"). Opponents of the shift may argue, for example, that ratings do not cover fraud risks, that rating agencies rely only on information provided by the issuer, and that the integrity and reliability provided by independent professionals such as investment banks and attorneys are discounted where investors read the offering papers less carefully or completely. *See* Schwarcz, *Universal Language*, *supra* note 9, at 252 n.76.

133. *See generally* Rhodes, *supra* note 14, at 323–28. *But cf.* Bottini, *supra* note 18, at 611–14 (arguing in a U.S. context that the SEC should be given explicit statutory authority to establish formal standards for NRSRO designation, require NRSROs to register with the SEC, and promulgate rules governing NRSROs). At some point, however, increased formalization and registration may increase costs beyond the level that justifies merit regulation.

134. Hadfield, *supra* note 7, at 10, 26. Professor Hadfield argues that this "traditional" approach is really stuck in the nineteenth century: "our historical perspective on the law is too modern [and thus] seems 'necessary' because we do not remember that it was not always as it is now." *Id.* at 10.

135. *Id.* at 25–26 (referring to this structure as the "constitutional law"). This structure is intended to create "the conditions favorable to the development of efficient private governance regimes for commercial entities, much as the role of the state is to structure the conditions favorable to the development of efficient private mechanisms—i.e., markets—for the production and distribution of goods and services." *Id.* at 36.

136. *Id.* at 26.

137. *Id.* at 40–41 (discussing the experience of private legal regimes in trade associations).

138. *Id.* at 49.

139. *Id.* at 38.

is its primary goal. Thus, it treats as absolute the value of the rights at stake while largely ignoring the costs.[141]

In the commercial context of rating securities, the State's legitimacy is not at issue and the rights at stake need not be treated as absolute. Accordingly, organizational regulation should be legally optimal.[142] The NRSRO-designation then derives its normative authority from being a form of organizational regulation—a minimal governmental structure, relying on the simple commitment mechanism of reputation, in which private institutions (rating agencies) operate under market incentives to allocate public resources.[143] NRSRO designation thus appears, at least conceptually, to be a justifiable form of regulation.

The remaining question is how to balance the protection provided by the NRSRO-designation with the goal of ensuring that a sufficient number of rating agencies receive such designation to assure competition. In this context, it has been proposed that NRSRO-designation be awarded to some foreign-recognized rating agencies, as well as to arms' length subsidiaries of domestic firms active in evaluating the business and securities of companies.[144] There should be relatively little risk if these entities are well-capitalized, have reputations for "quality financial analysis in the investment community," and have acceptable business plans to rate securities.[145] The risk could be further minimized by making any de novo applicant's NRSRO-status provisional for some trial period.[146] In this way, the "potential anticompetitive effect" of NRSRO designation can, consistent with the integrity of such designation, be reduced.[147] Reducing the anticompetitive effect also would mitigate any theoretical concern that rating agencies will engage in cartel behavior, such as by giving unnecessarily negative ratings or extracting oligopolistic profits.[148]

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140. Recall that in an economic context where health and safety are not at issue, the rationale for regulation is to improve efficiency. *See supra* note 65 and accompanying text.

141. Hadfield, *supra* note 7, at 41.

142. *Id.* at 56–57.

143. *See supra* notes 136–41 and accompanying text.

144. *See* Letter from Antitrust Division of the U.S. Department of Justice to the SEC 3 (Mar. 6, 1998) (on file with author) (commenting on the SEC's proposed amendments to Rule 15c3-1 regarding NRSRO designation; listing investment and commercial banks, insurance companies, and accounting and consulting firms as examples of the types of firms active in evaluating companies' business and securities).

145. *See id.* Consideration might even be given, for example, to firms that utilize alternative rating approaches, such as credit spreads, *cf. supra* note 29, and stock-price volatility, *see, e.g.*, *Process Reengineering*, OWC CREDIT COMMENTS, May 6, 1992 at 1, 2 (noting that, for publicly traded companies, stock-price volatility may signal credit troubles earlier than rating agencies become aware of them), *available at* http://www.erisks.com/reference/archive/142_23processre.pdf (last visited Apr. 26, 2001).

146. *See* Letter from Antitrust Division to the SEC, *supra* note 144, at 3 (proposing a 12–18 month trial period).

147. *See id.* at 1.

148. This does not, however, appear to be a realistic current concern; indeed, the prevalence of split ratings is evidence against cartel behavior. *See also* White, *supra* note 37, at 17–18 (observing that

D. Multinational Considerations

This article's analysis has thus far indicated that additional regulation of rating agencies is unnecessary and probably inefficient. This view is reinforced by the fact that rating agencies are multinational entities with human capital assets. As such, a rating agency subject to excessive regulation would be more likely than an ordinary multinational company to relocate to a foreign country that does not impose such regulation,[149] assuming the country has the educational infrastructure to supply the ongoing need for analysts.[150] This in turn might lead to a race to the bottom,[151] in which countries compete to reduce their level of regulation in order to attract rating agencies that wish to relocate. Reputational considerations might mitigate relocation to the extent that a rating agency prefers to comply with the regulation as an additional means of signaling to the market its reliability;[152] but ultimately, a rating agency would have to balance the cost of such compliance with the costs of relocating, including any perceived loss of reputation.

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rating agencies have not displayed widespread instances of moral hazard or improperly opportunistic behavior, apparently because reputational concerns discourage such behavior).

149. *Cf.* RICHARD W. JENNINGS ET AL., SECURITIES REGULATION 3 (7th ed. 1992) (observing that, because securities markets are increasingly international, "if one jurisdiction regulates more intensively than others, it may induce issuers—both domestic and foreign—to flee 'overregulation' by using a foreign market").

150. For example, a senior officer of a major rating agency disclosed to the author in confidence in connection with this article that the agency chooses not to open offices in countries where it feels the regulatory environment jeopardizes its independence, objectivity, or ability to develop and apply rating criteria. Confidential e-mail (June 13, 2001) (on file with author). Of course, the flexibility to relocate would be less in such dominant markets as the United States, especially to the extent the rating agency desires to continue to have its ratings qualify for the NRSRO securities law exemptions. Furthermore, a state could attempt to indirectly regulate foreign rating agencies that assign ratings to securities issued in its jurisdiction by directing enforcement at the issuer located in the state, much like a state can tax interest income paid to a foreign lender by requiring a domestic borrower to withhold a portion of the interest payable and turn it over to the state as a withholding tax. *See* Schwarcz, *Universal Language*, *supra* note 9, at 249.

151. In the United States, for example, the term "race to the bottom" generally refers to the tendency of corporations to incorporate in states with the least restrictive regulation, which in turn (because states derive revenue from corporate charters) motivates states to reduce their level of regulation. *See, e.g.*, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 91, 92–94 (Richard A. Posner & Kenneth E. Scott eds., 1980) (arguing this has led to a "steady lessening of the restrictiveness of state corporation laws"); Joseph W. Singer, *Real Conflicts*, 69 B.U. L. REV. 3, 63–65 (1989) (discussing the "race to the bottom" in relation to comity and the choice of law question in dispute resolution); Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, *reprinted in* 6 J. LEGAL STUD. 251 (1977). *But cf.* Joel P. Trachtman, *International Regulatory Competition, Externalization, and Jurisdiction*, 34 HARV. INT'L L.J. 47, 49 (1993) (arguing that regulatory competition sometimes can lead to more efficient and innovative practices).

152. Empirical evidence from the European Union suggests, for example, that to the extent advantageous in issuing securities, companies will comply with market standards that are even more stringent than legally required. *See* Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999—Part I*, 56 BUS. LAW. 653, 655 (2001) (examining how European Union issuers utilize the flexibility under E.U. law to choose, for preparation of disclosure documents, the securities law of either the issuer's home-State or the State in which the securities are issued, and finding that market forces "require European issuers of common stock to disclose more information and prepare disclosure documents more carefully than legal rules formally require").

A possible solution to this dilemma is to impose regulation on a global scale.[153] However, international regulation of rating agencies, like any other form of global regulation, would be inherently costly, if not impractical, in our "primitive" system of international law.[154] Thus, comprehensive international regulation would be unnecessary, costly, and impractical.

Even minimal international regulation, by analogy to the NRSRO-designation, appears unnecessary. A limitation of such a designation is that it is national, not international. Therefore, inconsistent designation criteria among countries might create confusion for cross-border financings, which have become increasingly common, and also could create the potential for inconsistent application of bank capital adequacy standards.[155] One may ask, then, whether there should be a globally recognized statistical rating organization (perhaps called GRSRO) designation.

This is not to suggest that global designation is necessary, or that inconsistent NRSRO designations are likely to give rise to confusion.[156] In a given transaction, the only relevant NRSRO designation would be that of the country where the applicable securities are issued.[157] Thus, in a cross-border securitization transaction where, for example, a company in State X sells receivables to an SPV in State Y, which in turn obtains financing by issuing securities through an SPV in State Z, only State Z's NRSRO designation would be relevant. There is little room for confusion.

On the other hand, GRSRO designation procedures, even if practical, would be costly because of the political maneuvering needed to achieve international consensus as well as the need to conform national securities laws that presently rely on NRSRO designation to the new designation procedure. Furthermore, a single GRSRO designation

153. *See* EATWELL & TAYLOR, *supra* note 73, at 6, 208–39 (arguing for the creation of a "World Financial Authority" to solve the dilemma that "financial markets know no borders. Yet regulatory power remains trapped within increasingly irrelevant national boundaries").

154. THOMAS BUERGENTHAL & HAROLD G. MAIER, PUBLIC INTERNATIONAL LAW 19 (2d ed. 1990) ("[v]iewed in terms of law-making, international law is a primitive legal system").

155. *See, e.g.*, *Standard & Poor's Official Response to the Basel Committee Proposals*, *supra* note 27, at 5 (cautioning that "international comparability" of ratings needs to be assured so that "all users understand what different agencies' ratings imply for risk weightings"). The Basel Committee itself notes that, because its approach places "increased reliance by [bank] supervisors on external credit assessment institutions, . . . it is therefore important that criteria for recognising these institutions [recognition being done by each national bank supervisory authority] be set at an appropriately high standard." A NEW CAPITAL ADEQUACY FRAMEWORK, *supra* note 23, at 33 (and, at 34, setting forth minimum criteria for such recognition).

156. Even the Basel capital adequacy proposal contemplates country-by-country NRSRO designation. *See A New Capital Adequacy Framework*, *supra* note 23, at 19.

157. *See* Schwarcz, *Universal Language*, *supra* note 9, at 237–38 (discussing that one must consider the local regulatory restrictions of countries in which securities are issued).

might exacerbate the anticompetitive effect of national designation by diminishing the ability of local rating agencies to germinate and grow.[158]

III. CONCLUSION

This article focuses on the extent to which rating agencies, which dominate the private ordering of public markets, should be regulated.

In an economic context, the normative rationale for regulation is to improve efficiency. Rating agencies are already motivated to provide accurate and efficient ratings because their profitability is directly tied to reputation. Historical data confirm that the reputational motivation is sufficient. Additional regulation of rating agencies thus would impose unnecessary costs and thereby diminish efficiency.

Theory confirms that reputation can be a substitute for regulation. At least for rating agencies, reputation drives much of the accountability that ordinarily is achieved through the democratic process.

Because rating agencies are somewhat representative of the emerging trend toward private ordering of traditionally public functions, this article's analysis also has implications for private ordering by NGOs other than rating agencies. As mentioned above, one of the central questions of private ordering is the extent to which it undercuts democratic authority. This article has shown that reputational constraints can be viewed as a normative complement to the democratic process (although these constraints are not a complete substitute for democratic accountability where, as with rating agencies, the NGO's reputation is relevant to only a subset of the State's populace).

The rating agency model further illustrates that organizational regulation—illustrated in a rating agency context by the NRSRO-designation—sometimes may be preferable to transactional regulation. Organizational regulation would be especially appropriate for NGOs that operate in commercial, financial, and other economic spheres, where protecting the state's legitimacy is not the primary goal.

The rating agency model also provides a reminder that, in a multinational context, NGOs subject to excessive regulation may be more likely than ordinary multinational companies to relocate to foreign states that do not impose such regulation. This is particularly likely where, as with rating agencies, the NGO's assets are human capital and foreign states have the requisite educational infrastructure. Reputational considerations might, however, mitigate relocation to the extent an NGO prefers to comply with regulation as a means of signaling its reliability.

158. *Cf. supra* notes 149–50 and accompanying text (discussing the anticompetitive effect of NRSRO designation). One might argue that a single global standard might help international investors, but markets already are able to judge the quality of rating agencies—indeed, market perception is the primary basis to date of NRSRO determination. *See* Rhodes, *supra* note 14, at 323.

This is not to say that the rating agency model is completely representative of NGO private ordering. To some extent rating agencies constitute a more difficult case because, unlike some NGOs which are really hybrid public-private entities,[159] rating agencies are purely private entities. On the other hand, rating agencies constitute an easier case of private ordering to the extent the normative regulatory goal of efficiency is less controversial in financial markets, where rating agencies operate, than in other domains. When examining other forms of private ordering, one thus must not only examine efficiency but also ask whether other regulatory goals should apply. This article is therefore only a first step in the analysis of a much larger problem.[160]

159. For example, one of the most well-known NGOs, The International Organization for Standardization (ISO), is a "worldwide federation of national standards bodies from some 130 countries." *Introduction to ISO*, *at* http://www.iso.ch/infoe/intro.htm (last updated Jan. 8, 1999). Some of these "national standards bodies" are official governmental bodies, others are private. *See Member Bodies*, *at* http://www.iso.ch/addresse/membodies.html (last visited Apr. 5, 2001).

160. I attempt to take additional steps towards that analysis in Steven L. Schwarcz, Private Ordering (unpublished manuscript, on file with the *University of Illinois Law Review*) (analyzing private ordering of commercial, financial, and other economic activities).