Report by the United States Securities and Exchange Commission on the Financial Guarantee Market: The Use of the Exemption in Section 3(a)(2) of the Securities Act of 1933 for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities

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XHIBIT A - Securities Act Release No. 6688 (February 6, 1987)

I. INTRODUCTION AND SUMMARY

In Section 105 of the Government Securities Act of 1986, Pub. L. No. 99-571, Congress directed the Securities and Exchange Commission to perform "a study of the use of the exemption contained in [S]ection 3(a)(2) of the Securities Act of 1933 (15 U.S.C. 77c(a)(2)) for securities guaranteed by banks, and the use of insurance policies to guarantee securities." More specifically, Congress directed that the Commission analyze:

(1) the impact of the guarantee provision of Section 3(a)(2) on investor protection and the public interest;

(2) the impact of the guarantee provision of Section 3(a)(2) on competition between banks and insurance companies and between domestic and foreign guarantors;

(3) whether and under what circumstances debt securities guaranteed by insurance policies should be exempt from registration under the Securities Act of 1933;

(4) the impact of such an exemption on investor protection and the public interest; and

(5) such other issues as the Commission deemed relevant.

In conducting this study, the Commission issued a release seeking public comment on the issues to be addressed in the study (Exhibit A); held a public hearing to explore further the views of interested parties; and consulted with the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, as Congress directed in Section 105.

This Report describes the use of financial guarantees issued by banks and insurance companies, the law governing such instruments, the regulatory schemes governing the entities that issue financial guarantees, and the role rating agencies play in this market. The Report also describes the treatment of the financial guarantee activities of banks and insurance companies under the Securities Act, including the exemption in Section 3(a)(2) for securities guaranteed by banks. In addition, the Report examines the nature of competition among domestic banks, foreign banks, and insurance companies, and how that competition may be affected by the exemption in Section 3(a)(2) for securities guaranteed by banks.

This Report finds that the financial guarantee activities of banks and insurance companies are functionally equivalent, but that the exemption from registration in Section 3(a)(2) for securities guaranteed by banks places insurance companies at an apparent competitive disadvantage in the financial guarantee market. This is because securities backed by bank guarantees are exempt from the registration provisions of the Securities Act, while securities guaranteed by insurance policies generally are not. The extent of the competitive disadvantage, however, cannot, on the basis of data gathered in the course of this study, be quantified.

This Report examines three approaches to remedy the apparent competitive disparity between banks and insurance companies: (1) specific legislation to exempt from registration provisions of the Securities Act debt securities guaranteed by insurance

companies; (2) elimination, by legislation or reinterpretation of Section 3(a)(2), of the exemption from registration for securities backed by bank guarantees; and (3) legislation providing for general exemptive authority under the Securities Act, which would allow the Commission to exempt appropriate classes of or transactions in securities. The approaches are analyzed in light of investor protection concerns and the public interest.

The Commission believes that arguments presented in favor of an insurance exemption deserve consideration. 1/ The Commission is concerned, however, that the presence of a guarantor may not be an adequate substitute for full disclosure of material information regarding a public offering. The Commission also recognizes that adoption of a statutory exemption for insured securities runs counter to the recommendations of Vice President Bush's Task Group on Regulation of Financial Services. Moreover, the legislative proposals for an insurance exemption presented to date suffer from various shortcomings that could be better addressed through Commission rulemakings or orders.

The Commission believes that any competitive disparity can be resolved through two approaches, both of which are consistent with investor protection and the public interest, as well as the

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1/ Commissioner Peters expressly disassociates herself from any implication that might be drawn from this Report on whether or how the general exemptive authority under the Securities Act recommended below might be used to grant relief to the insurance industry. The Commissioner believes it inappropriate and unnecessary, within the context of this Report, to suggest any prejudgment of this issue.

recommendations of the Bush Task Group. First, the Commission recommends that Congress amend the Securities Act to require registration of securities of publicly-held banks and thrifts. That recommendation would place the financial guarantee activities of banks and insurance companies on an equal footing under the Securities Act. Such a provision would, at the same time, ensure that investors in securities backed by bank guarantees receive full and fair disclosure under the Act's registration provisions. 2/

Second, the Commission recommends that Congress amend the Securities Act to provide authority for the Commission to grant exemptive relief from the registration provisions of the Securities Act. General exemptive authority under the Securities Act will allow the Commission to fashion relief, when appropriate and under circumstances consistent with the purposes of the Act, for securities and securities transactions that warrant exemption. 3/ Such an approach is also more flexible than a legislative exemption because exemptions fashioned through rulemaking or orders can be

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2/ The Commission believes that reinterpreting Section 3(a)(2) to require registration of securities backed by standby letters of credit is not appropriate. As a matter of statutory construction, such a reinterpretation turns on whether a security backed by a bank standby letter of credit is a security "guaranteed" by a bank. The Commission continues to believe that a standby letter of credit is tantamount to a guarantee, and that a security backed by a standby letter of credit is a security guaranteed by a bank. In any event, such a reinterpretation would not place the financial guarantee activities of all banks on a par with the financial guarantee activities of insurance companies because certain state banks have the power to issue other kinds of guarantees.

3/ General exemptive authority can be provided with or without repeal of Section 3(a)(2). If Section 3(a)(2) is repealed, general exemptive authority could be used to craft exemptions,

(Footnote continued)

adapted to respond to evolving market circumstances.

The federal banking regulators expressed differing views on the issues addressed by this Report. The staff of the Department of Treasury concluded that an exemption for securities guaranteed by insurance companies is not appropriate, and that the best way to alleviate any competitive disparity is to enact the Bush Task Group recommendation to amend Section 3(a)(2). The Department, however, supports reducing unnecessary burdens imposed by registration for bank guaranteed securities.

The Office of the Comptroller of the Currency took no position on whether the registration requirements for insured securities creates a competitive disparity or whether an exemption for such securities is appropriate at this time. The Office believes the Section 3(a)(2) exemption for securities guaranteed by banks remains appropriate when judged against Congress's purposes in imposing the registration requirements of the Securities Act, and believes that amendment of Section 3(a)(2) is appropriate only if taken in the context of the Task Group's entire legislative package.

The Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation did not comment on the issues raised by the Commission's study.

3/ (footnote continued)

if appropriate, for bank guaranteed securities as well as securities guaranteed by insurance companies. If Section 3(a)(2) is not repealed, exemptive authority could, if appropriate, be used to reduce significantly any competitive disparity in the financial guarantee market, to the extent consistent with investor protection, the public interest, and the purposes of the Act.

II. SECURITIES ACT REGISTRATION AND SECURITIES EXCHANGE ACT PERIODIC REPORTING PROVISIONS

Because this report primarily concerns the Securities Act treatment of securities backed by financial guarantees, this section describes generally the Securities Act's registration requirements. It also mentions briefly the periodic reporting requirements of the Securities Exchange Act of 1934 that are a consequence of Securities Act registration.

The Securities Act is designed "to provide full and fair disclosure of the character of securities sold" to the investing public. 4/ The Act accomplishes this goal by requiring that a registration statement and prospectus containing adequate and accurate information be filed with the Commission for each public offering. The prospectus must be provided to investors in the offering. The Act specifies the method and procedure of registration, and prescribes the content of registration statements, subject to the Commission's rulemaking powers. 5/ The Act also imposes civil liability on issuers, their directors, underwriters, lawyers, and accountants for material misstatements or omissions in registration statements, 6/ subject to certain defenses,

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4/ Preamble to the Securities Act.

5/ *See* Sections 6, 7, 8, and 10 and Schedules A and B of the Securities Act.

6/ This liability is imposed by Section 11. At the time of the Act's passage, one commentator noted the significance of Section 11:

> The Act seeks not only to secure accuracy in the information that is volunteered to investors, but also, and perhaps

(footnote continued)

including a series of reasonable care defenses. 7/

The theory underlying the Act's registration and disclosure provisions is that investors should be permitted to make their own decisions regarding the merits of a prospective investment, but that there should be placed in the market a body of facts that enable investors to make those decisions on an informed basis. 8/

(footnote continued)

6/ more especially, to compel the disclosure of significant matters which were heretofore rarely, if ever, disclosed. Civil liability is imposed largely as one appropriate means of accomplishing these ends * * *.

Shulman, Civil Liability and the Securities Act, 43 Yale L.J. 227 (1933).

In addition, Section 12(2) imposes civil liability upon any person who offers or sells any security (whether registered or not) by means of material misstatements or omissions.

7/ The reasonable care defense is not available to an issuer. See Section 11(b) of the Act. Neither reliance nor scienter need be proven in an action under Section 11. Section 12(2) likewise does not require proof of reliance or scienter. See generally L. Loss, Fundamentals of Securities Regulation 1015-17, 1021-34 (1983). In contrast, both reliance and scienter generally must be shown in a private damages action under Section 10(b) and Rule 10b-5 of the Exchange Act.

8/ Some have suggested that the required disclosure may be rather voluminous and complex, giving it only limited utility to unsophisticated investors. However, benefits still accrue to those investors, by the intermediation of brokers and others able to assimilate, condense, and communicate the information. See Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, printed for the use of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 1st Sess. XI (Comm. Print 1977) (citing Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171 (1933)).

Issuers of securities that are the subject of an effective registration statement also become subject to the periodic reporting requirements of Section 15(d) of the Securities Exchange Act. 9/ This requirement is founded on the theory that healthy and efficient securities markets require that there be adequate information publicly available about issuers whose securities are traded in those markets. The periodic disclosure provisions ensure continuous disclosure of material information to the marketplace through quarterly, annual, and other reports.

9/ Periodic reporting is also required under Section 13(a) for issuers with securities registered under Sections 12(b) (securities listed on a national securities exchange) and 12(g) (issuers with $5,000,000 or more in total assets (*see* Rule 12g-1) and a class of equity securities held of record by 500 or more persons).

III. THE FINANCIAL GUARANTEE MARKET

A "financial guarantee" may be defined as a third party's guarantee that another party's obligations in a financial transaction will be met. In the securities markets, financial guarantees are used to back issues of municipal and corporate bonds, commercial paper, and "structured financings." 10/ The primary providers of these financial guarantees are insurance companies, domestic banks, and foreign banks, through their domestic branches and agencies.

Financial guarantees first gained widespread acceptance in the 1970s to ensure payment of principal and interest on municipal bonds. In the municipal bond market, an issuer's purchase of a guarantee raises the market's perception of the creditworthiness of the municipality's obligation. This gives the municipality greater access to credit and allows it to pay lower interest rates to investors. 11/

Today, financial guarantees have become particularly important in structured financings. In a structured financing, a shell or special purpose entity issues securities, using the proceeds to

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10/ Freedman, Financial Guarantees: Too Hot to Handle? 86 Best's Rev. (Property/Casualty Ins. Ed.) 16 (Oct. 1985). Sometimes the insurance is purchased by another party, such as the sponsor of a unit investment trust to cover securities in the trust's portfolios. Such insurance may be in effect only so long as the insured security is held by the trust. The insurance allows the trust to get a higher rating for its portfolio as a whole.

11/ Freedman, supra note 10, at 18, 133.

purchase income-producing assets. The income from the assets is used to fund payments on the securities. The assets may consist of mortgages, leases, credit card receivables, automobile loans, trade receivables, or other assets generating cash flow. This financing technique, often described as the securitization of assets, allows the seller of the assets to convert them into cash. 12/

Structured financings have greatly increased during the past ten years. According to two commentators, structured financings accounted for 25% of total new corporate debt and preferred stock offerings in 1986, up from virtually zero in 1976. 13/ One observer has suggested that by the end of the decade the amount of securitized debt will dwarf the traditional corporate bond market. 14/

A. Bank Activity in the Financial Guarantee Market

Domestic banks, and foreign banks through their domestic branches and agencies, are major providers of financial guarantees, usually in the form of standby letters of credit. This section describes the development of standby letters of credit, the law

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12/ Letter from W. James Lopp, Chairman and President, Financial Security Assurance Inc., to Jonathan G. Katz, Secretary, SEC, dated March 13, 1987, at 5-6 ("Financial Security Assurance letter"); Shapiro, The Securitization of Practically Everything, Institutional Investor, May 1985, 197, 198.

13/ Financial Security Assurance letter at 5-6; letter from David C. Clapp, Partner, Goldman, Sachs & Co., to Jonathan G. Katz, Secretary, SEC, dated March 10, 1987, at 2.

14/ Shapiro, *supra* note 12, at 198.

governing such instruments, applicable banking regulations, and the continued growth in the use of bank standby letters of credit to support securities.

1. Development of Standby Letters of Credit

Standby letters of credit evolved from traditional commercial letters of credit, although the two instruments serve very different functions. Briefly described, a letter of credit is an

> original undertaking by one party (the issuer) to substitute his financial strength for that of another (the account party), with that undertaking to be triggered by the presentation of a draft or demand for payment and, often, other documents. The credit arises in a number of situations, but generally, the account party seeks the strength of the issuer's financial integrity or reputation so that a third party (the beneficiary of the credit) will give value to the account party. The beneficiary extends credit by selling goods or services to the account party on credit, by taking the account party's negotiable paper, or by lending the account party money. 15/

The origins of commercial letters of credit have been traced back as far as the Roman Empire. 16/ They were developed to facilitate trade between distant buyers and sellers, not commercially acquainted with each other, by reducing uncertainties--such as doubts as to a buyer's intentions, reliability, good faith, or difficulties of foreign litigation--that occur when someone sells goods or services to a buyer in a foreign land. 17/

15/ J.F. Dolan, The Law of Letters of Credit: Commercial and Standby Credits (1984) at ¶ 2.02.

16/ Lloyd-Davies, Standby Letters of Credit of Commercial Banks, 113 Staff Studies, Board of Governors of the Federal Reserve System 15, 18-19 (Jan. 1982).

17/ Verkuil, Bank Solvency and Guaranty Letters of Credit, 25 Stan. L. Rev. 716, 718 (1973).

The letter of credit reduces uncertainties by creating an absolute, independent obligation. Payment must be made upon presentment of the specified documents regardless of any dispute between the buyer and seller concerning their contract. 18/

The principal difference between the traditional letter of credit and the standby letter of credit is that "whereas in the classical setting, the letter of credit contemplates payment upon performance, 'the standby credit' * * * 'contemplates payment upon failure to perform.'" 19/ Thus, economically, a standby letter of credit fulfills the same purpose as a guarantee. 20/ Standby letters of credit are used as security devices in a variety of contexts outside the traditional area of the international sale of goods. For example, they have been used to insure construction loans, as quasi-performance bonds, to support the issuance of publicly-held securities, 21/ and even in child-custody agreements. 22/

18/ See, e.g., Association de Azucareros de Guatemala v. United States Nat'l Bank, 423 F.2d 638, 641 (9th Cir. 1970).

19/ Katskee, The Standby Letter of Credit Debate-the Case for Congressional Resolution, 92 Banking L.J. 697, 699 (1975).

20/ Lloyd-Davies, supra note 16, at 32. See also New York Clearing House letter at 4 ("Whether analyzed from a functional or a structural perspective, a standby letter of credit is virtually identical to a document styled as a guarantee.")

21/ See Verkuil, supra note 17, at 717, 721-22.

22/ Tischendorf v. Tischendorf, 321 N.W.2d 405 (Minn. 1982), cert. denied, 460 U.S. 1037 (1983).

Generally, however, commercial banks have lacked the corporate power to undertake to answer for debts of others,. that is, to engage in the business of suretyship. 23/ Because of this separation of functions between banks and surety companies, there existed until recently uncertainty concerning the scope of permissible bank activity in the standby letter of credit business. 24/ Authorities now generally agree that banks may issue standby letters of credit for two reasons.

First, the issuance of standby letters of credit is considered to be consistent with the business of banking. From a banking law perspective, a standby letter of credit involves the provision of financial support for the transactions of others, which "is the business of banking. The form of the financing, whether it be a loan of money, a loan of credit or some other accommodation apt to the occasion, is immaterial." 25/ In determing whether to

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23/ Harfield, Bank Credits and Acceptances 154 (5th ed. 1974). Certain state banks, however, do have the power to guarantee the debts of others. See, e.g., New York Banking Law § 96.9 (McKinney Supp. 1987) (providing that New York State-chartered banks may "execute and deliver such guaranties as may be incidental to carrying on the business of a bank * * *"). In addition, a national bank may issue a guarantee "if it has a substantial interest in the performance of the transaction" or a segregated deposit covering the bank's total potential liability. 12 C.F.R. 7.7010.

24/ Harfield, supra note 23, at 154-55.

25/ Id. at 163. The Superintendent of Insurance of the State of New York, for example, has characterized financial guarantee insurance as a banking function, not insurance. Transcript of Commission hearing, March 23, 1987, at 21 (statement of

(footnote continued)

issue a standby letter of credit, a bank undertakes an analysis of the account party's creditworthiness. Such an analysis is "a typical financial-judgment process similar to the ones the bank makes in any commercial-loan setting." 26/

Second, a standby letter of credit can be distinguished from a guarantee since the obligation of an issuer of a standby letter of credit is independent of the underlying contract. The obligation arises only upon presentment of documents and thus is a primary obligation. A true guarantee, on the other hand, requires payment only secondarily upon the fact of default by the primary obligor. 27/

The United States bank regulators have determined that the issuance of standby letters of credit is a permissible banking activity. For example, the Comptroller of the Currency's

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25/ (footnote continued)

James Corcoran, Superintendent of Insurance of the State of New York) ("Commission hearing"). See also letter from John W. Weaber, Senior Vice President, Meridian Bancorp, Inc. to Jonathan G. Katz, Secretary, SEC, dated March 13, 1987, at 1 ("[t]he issuance of letters of credit to guarantee debt securities is not an extraordinary banking practice, but instead is something done in the normal course of business for banks") ("Meridian Bancorp letter").

26/ Dolan, supra note 15, at ¶ 12.03[1][b]. See also Meridian Bancorp letter at 1 ("Requests for stand-by letters of credit are subject to the same review and approval procedures as loan and other credit requests. The procedures require approval according to pre-established dollar lending authorities, and for stand-by letters of credit, approval is generally by a [c]ommittee comprised of senior lenders and loan administrators").

27/ Dolan, supra note 15, at ¶ 12.03[1][b].

regulations provide that

> [a] national bank may issue letters of credit permissible under the Uniform Commercial Code or the Uniform Customs and Practice for Documentary Credits to or on behalf of its customers. As a matter of sound banking practice, letters of credit should be issued in conformity with the following:
>
> (a) Each letter of credit should conspicuously state that it is a letter of credit or be conspicuously entitled as such;
>
> (b) The bank's undertaking should contain a specified expiration date or be for a definite term;
>
> (c) The bank's undertaking should be limited in amount;
>
> (d) The bank's obligation to pay should arise only upon the presentation of a draft or other documents as specified in the letter of credit, and the bank must not be called upon to determine questions of fact or law at issue between the account party and the beneficiary;
>
> (e) The bank's customer should have an unqualified obligation to reimburse the bank for payments made under the letter of credit. 28/

The courts also have held that the issuance of standby letters of credit is an incident of the banking business and is not beyond the power of banks. 29/

The primary sources of law governing both traditional and standby letters of credit are Article 5 of the Uniform Commercial Code ("UCC") and the Uniform Custom and Practice for Documentary

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28/ 12 C.F.R. 7.7016. See also 12 C.F.R. 332.1 (FDIC regulation prohibiting state nonmember insured banks from acting as surety, but allowing "letters of credit made or issued in the usual course of banking business").

29/ See, e.g., Barclays Bank D.C.O. Mercantile Nat'l Bank 481 F.2d 1224, 1236 (5th Cir. 1973), cert. dismissed, 414 U.S. 1139 (1974); Bossier Bank & Trust Co. v. Union Planters Nat'l Bank, 550 F.2d 1077 (6th Cir. 1977).

Credits ("UCP"). 30/ Article 5 has been enacted in all 50 states. Although not a comprehensive compilation of letter of credit law, it provides a legal framework governing such letters, including rules on matters such as the circumstances under which payment can be blocked. 31/ The UCP, on the other hand, is a compilation of letter of credit customs and usages prepared by the International Chamber of Commerce in Paris. 32/ The UCP is not statutory law, and its rules must be incorporated into each letter of credit by specific wording in the letter itself. 33/ When a letter of credit is issued subject to the UCP, the UCP provides rules governing such questions as the liabilities and responsibilities of bank issuers, 34/ transfer of credits, 35/ and the character of the documents presented. 36/

30/ McLaughlin, The ABCs of Letters of Credit: Important Financial Instruments, Nat'l L.J., July 28, 1986, at 40.

31/ See UCC § 5-114(2).

32/ The UCP was revised in 1983, and that revision became effective on October 1, 1984. See Uniform Customs and Practice for Documentary Credits (1983 Revision), International Chamber of Commerce Publication No. 400. All references herein are to UCP 400. For a description of the 1983 revisions and a comparision with the 1974 UCP revision, see Byrne, The 1983 Revision of the Uniform Customs and Practice for Documentary Credits, 102 Banking L.J. 151 (1985).

33/ See UCP, Art. 1.

34/ See UCP, Arts. 15 through 21.

35/ See UCP, Art. 54.

36/ See UCP, Arts. 22 through 42. In New York, Alabama, and Missouri, if a letter of credit is issued subject to the UCP, then Article 5 of the UCC does not apply to that credit.

As noted above, payment on a letter of credit is conditioned upon the presentation of specified documents. This fundamental principle of letter of credit law is contained in Article 4 of the UCP and Section 5-114 of the UCC. The issuing bank does not determine whether in fact the beneficiary has performed or acted in a certain way; it checks only to determine whether the beneficiary has presented the requisite documents. 37/ Stated differently,

> The engagement is a letter of credit if the issuer has a primary obligation that is dependent solely upon presentation of conforming documents and not upon the factual performance or nonperformance by the parties to the underlying transaction. 38/

37/ Article 4 provides that "[i]n credit operations all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate." As discussed above, this principle distinguishes a standby letter of credit from a true guarantee, which requires payment upon the fact of default by the primary obligor. UCC § 5-114 provides that "[a]n issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary."

38/ Republic Nat'l Bank v. Northwest Nat'l Bank, 578 S.W.2d 109, 115 (Tex. 1978) (emphasis in original). Accord Wichita Eagle & Beacon Pub. Co. v. Pacific Nat'l Bank, 493 F.2d 1285 (9th Cir. 1974) (holding that document styled as a letter of credit was a guarantee because the issuing bank was required to determine fact of default).

A letter of credit may be either revocable or irrevocable, but should indicate which it is. UCC § 5-103(1)(a); UCP, Art. 7. Bank standby letters of credit are generally irrevocable. Revocable credits, of course, are of limited utility to beneficiaries. In the absence of an express statement, the UCP provides that the credit is revocable. UCP Art. 7b and c. While the UCC is silent on the issue, American courts have generally held that credits that are not subject to the UCP and are not labelled as revocable shall be construed as irrevocable. See, e.g., West Va. Hous. Dev. Fund v. Sroka, 415 F. Supp. 1107 (W.D. Pa. 1976); cf. Beathard v. Chicago Football Club, 419 F. Supp. 1133 (N.D. Ill. 1976) (holding that credit subject to the UCP and not designated as irrevocable was a revocable credit).

Because a standby letter of credit is conditioned solely on the presentation of specified documents and the obligation of the bank is independent of the underlying contract, the issuer of the credit possesses virtually no defenses against payment. The only exception is fraud in the presentment of the documents. 39/ Indeed, unlike a true guarantee, the defenses available to a guarantor under the law of suretyship are not available to an issuer of a standby letter of credit. Accordingly, it appears that an irrevocable standby letter of credit provides the holder of a security backed by such letter with at least as much protection as a true guarantee.

39/ See U.C.C § 5-114(2)(b); § 3-302; § 3-307; see also memorandum to JoAnn Palazzo, General Counsel, Bond Investors Guaranty Insurance Company, from Mudge Rose Guthrie Alexander & Ferdon, at 15-16 ("Mudge Rose memorandum"), attached to letter from Robert A. Meyer, President, Bond Investors Guaranty Insurance Company, to Jonathan G. Katz, Secretary, SEC, dated March 13, 1987 ("Bond Investors Guaranty Insurance Company letter") (concluding that an investor who takes the security for value, in good faith, and without notice of underlying fraud in the transaction is a holder in due course who must be paid despite allegation of fraud in the inducement); letter from Anne H. Scales, Counsel, First Interstate Bancorp, to Jonathan G. Katz, Secretary, SEC, dated March 12, 1987, at 5 ("We are unaware of any defenses at law which are available to a bank that would permanently excuse performance of its obligations under a standby letter of credit") ("First Interstate Bancorp letter"); letter from John F. Lee, Executive Vice President, New York Clearing House, to Jonathan G. Katz, Secretary, SEC, dated March 20, 1987, at 4-5 ("the obligation of the bank that issues the letter of credit is unaffected by any defects or invalidity in the underlying transaction") ("New York Clearing House letter").

It should be noted, however, that the Commission is not aware of any cases ruling on whether fraud in the inducement of the issuance of a standby letter of credit backing a publicly-held security is a defense to payment.

The issuer of a standby letter of credit is entitled to immediate reimbursement by the account party for payments properly made under the standby letter of credit. 40/ Usually, prior to the issuance of the standby letter of credit, the bank and the account party enter into a reimbursement agreement which specifies the documents against which payment is to be made, and the rights and remedies of the issuing bank, including the terms of reimbursement. 41/

2. Regulation of the Issuance of Standby Letters of Credit

a. Domestic Banks

Prior to 1974, the issuance of standby letters of credit by United States commercial banks was virtually unregulated. In response to the rapid growth in the issuance of standby letters of credit, 42/ increased concern about the risks of such activities to banks, 43/ and the collapse of a national bank into

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40/ *See* UCC § 5-114(3); UCP, Art. 16a. The OCC's interpretive ruling at 12 C.F.R. 7.7016 requires that an issuing bank have an unqualified right of reimbursement. *See supra* pp. 14-15.

41/ Ryan, *Letters of Credit Supporting Debt for Borrowed Money: The Standby as Backup*, 100 Banking L. J. 404, 411-12 (1983).

42/ One source estimated that the amount of outstanding standby letters of credit grew from $2 million in 1967 to $6 million in 1973. *Regulation of Standby Letters of Credit: Hearings Before the Senate Committee on Banking, Housing and Urban Affairs*, 94th Cong., 2nd Sess. 122 (1976) (statement of Russell Fraser, Paine, Webber, Jackson & Curtis, Inc.).

43/ Concerns were expressed that the largely unregulated nature of that activity could imperil bank solvency. One writer concluded:

> While recent history has not been characterized by a significant number of bank failures, there is no reason why the recklessness of overly optimistic loan officers in guaranty letter of credit transactions could not result in an inundation of failures. Verkuil, *supra* note 17, at 728.

receivership, 44/ the federal bank regulators in the mid-1970's imposed a number of restrictions on the issuance of standby letters of credit.

The Office of the Comptroller of the Currency promulgated regulations that required national banks to include the issuance of standby letters of credit with in the lending limits prescribed by federal law. 45/ Under those limits, the total loans and extensions

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44/ In October 1973, the United States National Bank of San Diego collapsed into receivership. That bank had issued a large number of standby letters of credit, often for the benefit of companies controlled by the bank's chief stockholder. When the bank's assets were segregated, they had to be offset against $90 million in claims on standby letters of credit. Verkuil, Bank Solvency and Standby Letters of Credit: Lessons from the USNB Failure, 53 Tul. L. Rev. 314, 315 (1979).

45/ See 12 C.F.R. 7.1160 (1983). In 1983, the OCC rescinded this regulation following amendments to 12 U.S.C. 84, and incorporated its substance in a new regulation, 12 C.F.R. Part 32. Participations in a standby letter of credit are subject to the same principles as participations in a loan. 12 C.F.R. 32.107. Thus, the portion of a standby letter of credit sold on a nonrecourse basis is not applied to the selling bank's lending limits. Id.

Court decisions are conflicting on whether a bank's standby letter of credit is enforceable against the bank even though the letter of credit exceeds the bank's lending limits to the account party. Compare First American Nat'l Bank v. Alcorn, Inc., 361 So. 2d 481, 490 (Miss. 1978) (letter of credit enforceable) with International Dairy Queen, Inc., v. Bank of Wadley, 407 F. Supp. 1270, 1272 (M.D. Ala. 1976) (letter of credit not enforceable). At least one writer has suggested that the better view is that the letter of credit should be enforceable, since the penalties are provided by statute and do not include voidability of the related bank credit. Ryan, Letters of Credit Supporting Debt Instruments, Letters of Credit and Bankers' Acceptances 1986, at 481-82 (citing 12 U.S.C. 93)(among other things, bank director who participates in or assents to the violation is liable for the damages which the national bank sustains as a result of such violation).

of credit not fully secured made to one person by a national bank may not exceed fifteen percent of the bank's unimpaired capital and unimpaired surplus. 46/ Fully secured loans may not exceed ten percent of capital and surplus. 47/ In addition, federal law limits loans that may be made to affiliates. 48/

The Federal Reserve Board promulgated similar regulations for state member banks, requiring that standby letters of credit must not, when combined with other extensions of credit, exceed lending limits imposed by state law and limits on loans to affiliates. 49/ The Federal Deposit Insurance Corporation

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46/ 12 U.S.C. 84(a)(1). Many state banking laws have similar restrictions. See, e.g., N.Y. Banking Law § 103 (McKinney Supp. 1987)

47/ 12 U.S.C. 84(a)(2). This limitation is separate from the fifteen percent limitation in 12 U.S.C. 84(a)(1).

48/ Under Section 23A of the Federal Reserve Act, 12 U.S.C. 371c(a), loans and extensions of credit by member banks to an affiliate are subject to a limit of 10 percent of capital and surplus, and the aggregate of all loans and extensions of credit to affiliates is subject to a limit of 20 percent of capital and surplus.

49/ See 12 C.F.R. 208.8(d)(2)(i). Participations are treated somewhat differently than under the OCC rule. See 12 C.F.R. 208.8(d)(2)(iii). In addition to requiring that standby letters of credit be treated the same as loans for purpose of the lending limits, the Federal Reserve Board requires that the credit analysis required to be performed prior to the issuance of a standby letter of credit be the same as that performed when making a loan. 12 C.F.R. 208.8(d)(2)(ii).

adopted similar regulations for insured state non-member banks. 50/

In addition, regulators required that standby letters of credit be disclosed on bank reports of condition. The required disclosure varies according to the size of the bank and whether it has foreign offices. 51/ These reporting requirements do not distinguish between standby letters of credit backing financial obligations, such as publicly-held securities, and those backing other obligations, such as performance contracts. 52/

50/ See 12 C.F.R. 337.2. Under this rule, participations in a standby letter of credit are treated in the same manner as under the OCC rule. See supra note 49. Under the New York Banking Law, an extension of credit by means of a standby letter of credit is deemed to be subject to the New York lending limits. N.Y. Banking Law § 1031 (McKinney Supp. 1987).

51/ See Schedule RC-L (Commitments and Contingencies) of the Reports of Condition and Income.

Although securities issued by banks are exempt from the registration provisions of the Securities Act (see infra pp. 61-62), publicly-held banks are subject to the registration provisions of the Securities Exchange Act of 1934. Administrative authority over those provisions is vested in the banking authorities, pursuant to Section 12(i). In the financial statements filed with their periodic reports, banks must disclose certain information about their standby letter of credit activity. See 12 C.F.R. 11.928(d) (OCC rules); 12 C.F.R. 206.7(e)(12)(vii) (FRB rules); 12 C.F.R. 335.621 (FDIC rules); see also 12 C.F.R. 208.8(d)(3) (FRB rule requiring that each state member bank adequately disclose amount of standby letters of credit in its published financial statments); 17 C.F.R. 210.9-03 (Commission rules for balance sheets of bank holding companies).

52/ Nor do the data reported include net open postions, maturity distributions, concentrations, collateralizations, or drawndowns and losses. See Chessen, Off-Balance-Sheet Activities: A Growing Concern?, Regulatory Rev. 15 (May, 1986).

Moreover, bank capital ratio requirements now take into account standby letters of credit. Although these regulations do not provide specific capital requirements for off-balance sheet risks such as standby letters of credit, 53/ the volume and quality of such risks may, on a case-by-case basis, increase a bank's capital requirements. 54/

Early in 1987, the United States bank regulatory authorities and the Bank of England jointly requested public comment on a proposed risk-based capital framework for banks and bank holding companies. 55/ This proposal would significantly affect the capital

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53/ Because standby letters of credit are, from an accounting perspective, contingent liabilities, they are not disclosed as line items on balance sheets.

54/ See 12 C.F.R. 3.10 (OCC rule providing that "higher capital ratios may be appropriate for: * * * [a] bank having a high proportion of off-balance sheet risks, especially standby letters of credit"); 12 C.F.R. Part 225 App. A (FRB guidelines stating that "[p]articularly close attention will be directed to risks associated with standby letters of credit * * *"); 12 C.F.R. 325.3(a) (FDIC rule providing that minimum adequate capital amount may be increased for banks having among other things, "off-balance sheet risk").

55/ Agreed Proposal of the United States Federal Banking Supervisory Authorities and the Bank of England on Primary Capital and Capital Adequacy Assessment (January 8, 1987). The Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency subsequently published the proposal as rule proposals. See 52 Fed. Reg. 5119 (February 19, 1987) (FRB proposal), 52 Fed. Reg. 11476 (April 9, 1987) (FDIC proposal); 52 Fed. Reg. 23045 (June 17, 1987) (OCC proposal). Prior to this proposal, similar risk-based capital frameworks were proposed by the United States regulators, but not adopted. See 51 Fed. Reg. 10602 (March 25, 1986) (OCC proposal) 51 Fed. Reg. 6126 (February 20, 1986)(FDIC proposal); 51 Fed. Reg. 3776 (January 31, 1986) (FRB proposal).

required for issuing standby letters of credit. Among other things, this proposal would assess a capital requirement against certain off-balance sheet risks, including standby letters of credit and other financial guarantees, by means of a two-step conversion formula. The formula would, in effect, translate off-balance sheet exposures into a rough on-balance sheet equivalent. First, the face amount of an off-balance sheet obligation would be translated into an on-balance sheet "credit equivalent amount." Second, the resulting credit equivalent amount would be assigned one of five risk categories used for on-balance sheet assets, based upon the type of obligor and the remaining maturity of the off-balance sheet item and qualifying collateral support. Standby letters of credit that back publicly-held securities generally would be placed in the highest risk category. These standards, if adopted, may increase the cost of standby letters of credit, thus making it difficult for banks to compete with insurance companies as financial guarantors. 56/

56/ See letter from Laurie S. Schaffer, Government Relations Counsel, American Bankers Association, to Jonathan G. Katz, Secretary, SEC, dated March 16, 1987, at 8 ("American Bankers Association letter"); Financial Security Assurance letter at 21 and B-2; Weiner, Some Banks Turn More Cautious in Issuing Standby Credit Letters, Am. Banker, Feb. 5, 1987, at 1, 12.

In the 1970s, Congress expressed concern over the growth in standby letters of credit and considered legislation that would have placed additional restrictions on the issuance of standby letters of credit. Generally, in addition to placing

(footnote continued)

Standby letters of credit generally are not considered to be "deposits" for purposes of deposit insurance. 57/ Thus, holders of securities backed by standby letters of credit are not protected by federal deposit insurance. In the event of bank failure, courts have held that a claim under a standby letter of credit is provable against the FDIC in its capacity as receiver. 58/ These claims are provable even when no drafts are presented prior to insolvency, if three conditions are met. First, the claims must have been in existence before the insolvency and must not be dependent on new contractual obligations arising after insolvency. Second, total liability must be certain at the time the beneficiaries sue the bank's receiver. Third, the claims must be made

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56/ (footnote continued)

standby letters of credit within the lending limits, those bills would have made standbys subject to reserve requirements, placed limits on the amount of standbys a bank could issue based on its capital, and required full disclosure of amounts of standby letters of credit as a line item on balance sheets.

The federal banking regulators generally opposed the legislation, preferring administrative action. See Regulation of Standby Letters of Credit: Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 2nd Sess. 5-10 (1976). The bills were not enacted.

57/ FDIC v. Philadelphia Gear Corp., 106 S. Ct. 1931 (1986).

58/ FDIC v. Liberty Nat'l Bank & Trust Co., 806 F.2d 961, 966 (10th Cir. 1986); First Empire Bank-New York v. FDIC, 572 F.2d 1361, 1367-69 (9th Cir.), cert. denied, 439 U.S. 919 (1978).

in a timely manner. 59/ Thus, beneficiaries of standby letters under which liability has been established prior to insolvency are entitled to share ratably with other creditors in the distribution of assets.

b. Domestic Branches and Agencies of Foreign Banks

Branches and agencies of foreign banks are operational arms conducting business in the United States under licenses granted either by the Comptroller of the Currency or a state authority. 60/ Branches and agencies are not separate legal entities from the foreign bank.

The International Banking Act ("IBA"), 61/ which was enacted in 1978, provides for federal regulation and supervision of foreign bank operations in the United States and establishes "the principle of parity of treatment between foreign and domestic banks in like circumstances." 62/ Prior to the enactment of the IBA, the only branches and agencies of foreign banks operating

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59/ Id. It appears that the requirement that the claims have been in existence prior to insolvency requires that the triggering event, such as default by the issuer of the primary obligation, must have occurred prior to insolvency. See FDIC v. Liberty National Bank & Trust Co., 806 F.2d at 970.

60/ Branches and agencies of foreign banks licensed by the OCC are sometimes referred to as "federal branches and agencies," and branches and agencies licensed by a state authority are sometimes referred to as "state branches and agencies."

61/ 12 U.S.C. 3101 et seq.

62/ S. Rep. No. 1073, 95th Cong., 2d Sess. 2 (1978).

in the United States were those licensed by the states. Under the IBA, a foreign branch or agency licensed and supervised by the Comptroller of the Currency may operate in any state in which it is not already operating a state-licensed branch or agency and where the establishment of a branch or agency by a foreign bank is not prohibited by state law. Any such federal branch or agency is entitled to the same rights and privileges, and is subject to the same duties, restrictions, penalties, liabilities, conditions, and limitations that would apply to a national bank doing business in the same location. 63/

In recognition of the fact that a branch or agency is not a separately incorporated entity, the IBA prescribes a regulatory structure for federal branches and agencies that differs somewhat from that applicable to domestic banks. The most significant differences are: (1) limitations and restrictions are based on the capital stock and surplus of the foreign bank, not the branch or agency; 64/ (2) federal agencies and branches are not generally subject to United States capital requirements, but may be required by the Comptroller of the Currency to maintain capitalization requirements through the maintenance of deposits in a national bank located in the same state; 65/ and (3) in the event of threatened insolvency of the foreign bank, the Comptroller may

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63/ 12 U.S.C. 3102(b); 12 C.F.R. 28.4.

64/ Id.

65/ 12 U.S.C. 3102(g).

appoint a receiver to take possession of all property and assets of the foreign bank in the United States in order to pay the claims of all depositors and creditors. 66/

With regard to their standby letter of credit activity, federal branches and agencies are subject to the lending limits, although the limits are based upon the dollar equivalent capital and surplus of the foreign bank. 67/ The disclosure of standby letter of credit volume required of federal branches and agencies on bank reports of condition is similar to that required of domestic banks. 68/

State licensed branches and agencies of foreign banks generally are subject to a similar regulatory scheme as state-chartered domestic banks. In most cases, state branches and agencies have similar powers and are subject to similar restrictions as state-chartered banks. 69/ Thus, for example, the New York Superintendent of Banking may take possession of the business and property of a New York branch or agency whenever an event occurs

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66/ 12 U.S.C. 3102(j).

67/ 12 U.S.C. 3102(b); 12 C.F.R. 28.101.

68/ *See* 12 C.F.R. 28.13.

69/ As discussed *infra* pp. 62-64, the Commission has taken the position that securities issued or guaranteed by a domestic branch or agency of a foreign bank are exempt from registration under Section 3(a)(2) of the Securities Act only if the nature and extent of federal and/or state regulation and/or supervision of the particular branch or agency is substantially equivalent to that applicable to federal or state chartered domestic banks doing business in the same jurisdiction.

that would permit the Superintendent to take possession of the business and property of a state-chartered bank. 70/ Depositary branches and agencies are subject to the same limitations on loans and other extensions of credit, based on the foreign bank's capital, as state-chartered banks, although non-depositary branches and agencies generally are not. 71/ State banking regulators may impose asset maintenance requirements on branches and agencies. 72/ State branches and agencies are required to file with state and federal authorities periodic reports of condition, similar to those filed by state-chartered banks. 73/ The Federal Reserve Board has residual examination authority over both state and federal branches and agencies. 74/

Unlike domestic banks, foreign banks with domestic branches and agencies for the most part are not subject to United States capital ratio requirements. This distinction is consistent with

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70/ N.Y. Banking Law § 606(4) (McKinney 1971).

71/ See, e.g., Cal Fin. Code § 1756(b)(5) (West Supp. 1987) (applicable to depositary agencies and branches; non-depositary agencies and branches are not subject to lending limits); New York Banking Law § 202-f (McKinney Supp. 1987) (applicable to branches). New York agencies, which are prohibited from taking retail deposits, are not subject to the lending limits.

72/ See, e.g., New York Banking Law § 202-b (McKinney Supp. 1987); Ill. Ann. Stat. Ch. 17 ¶ 2720 (Smith-Hurd 1981).

73/ See, e.g., New York Banking Law § 204 (McKinney 1971); Cal. Fin. Code § 1757(a) (West Supp. 1987); 12 U.S.C. 3105(b)(2).

74/ 12 U.S.C. 3105(b)(1).

the principles of international banking regulation set forth in the Basle Concordat, 75/ a guide for allocation of supervisory responsibility and greater cooperation among domestic bank regulatory authorities. While host and parent country banking authorities share responsibility for supervision of branches and agencies generally with respect to liquidity, as to solvency, branches and agencies primarily are supervised by the parent country banking authority. 76/

c. Growth in Volume of Standby Letters of Credit

Between year end 1980 and September 1986, the amount of outstanding standby letters of credit issued by domestic banks and domestic branches and agencies of foreign banks increased by nearly a factor of five, growing from $51 billion in 1980 to $254.8 billion in 1986. During this period, the amount issued by domestic banks increased from $47 billion to $175 billion, while the amount issued by domestic branches and agencies of foreign banks increased from $4 billion to $86 billion. Thus, foreign banks' share of outstanding standby letters of credit has grown from approximately 9% in 1980 to 34% as of September 1986. In the municipal bond market alone, it has been estimated that 69% of all new letters of credit issued in 1986 were issued by branches

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75/ Committee on Banking Regulations and Supervisory Practices, Principles for the Supervision of Banks' Foreign Establishments, Int'l Legal Materials 900 (1983).

76/ Id. at 905-906.

and agencies of foreign banks. 77/

The market for standby letters of credit is dominated by the large banks. 78/ Banks with assets greater than $3 billion account for 90% of all standby letters of credit issued by domestic banks. Many smaller banks, however, have significant off-balance sheet activities, including standby letters of credit, relative to their capital. 79/ For domestic banks, standby letters of credit now equal aggregate bank capital. 80/

Precise figures are not available on how much of the growth has been in letters of credit backing publicly-held securities. One source estimates that 60% of all standby letters of credit now back financial obligations, including publicly-held securities. 81/ Others have indicated that over one-half of the outstanding standby letters of credit are for credit enhancement. 82/

Despite the overall growth during the last seven years, the rate of growth in standby letters issued by domestic banks recently

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77/ See *infra* p. 70.

78/ Chessen, *supra* note 50, at 2.

79/ *Id*.

80/ Bennett, *Off Balance Sheet Risk in Banking: The Case of Standby Letters of Credit*, Fed. Res. Bank of San Fran. Econ. Rev. 19, 23 (Winter 1986).

81/ Chessen, *supra* note 50, at 12. As discussed *supra* pp. 11-12, standby letters are used to support many transactions other than security issuances, including bid and performance contracts.

82/ See Johnstone and Mayher, *Standby Letters of Credit, Revolving Underwriting Facilities (RUFS) and Loan Commitments*, March, 1986, at 14.

has slowed. In fact, the amount of outstanding letters of credit of domestic banks actually declined slightly in the first nine months of 1986. This may be due in part to increased regulatory monitoring, proposals for risk-based capital requirements (*see supra* pp. 23-24), and concerns of statistical rating organizations. 83/ Also, few major United States banks have the highest credit rating, an important competitive factor in the financial guarantee market. 84/ Finally, many bankers believe that competition, particularly from foreign banks, has driven fees for standby letters of credit below a level sufficient to compensate banks for the risks assumed. 85/

Information on the performance and default record of standby letters of credit is somewhat dated and also does not distinguish between standby letters of credit backing securities and other types of standby letters of credit. A 1979 survey of 28 banks by the staff of the Federal Reserve Board indicated very low rates of drafts on standby credits and no defaults on those drafts. 86/ Drafts paid amounted to slightly over two percent of the total amount guaranteed by standby letters of credit. Over 98% of the amounts paid out were recovered immediately from the

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83/ Chessen, *supra* note 52, at 7.

84/ *See infra* p. 71.

85/ *See* Johnstone and Mayher, *supra* note 82, at 16; Weiner, *supra* note 56, at 12.

86/ Lloyd-Davies, *Survey of Standby Letters of Credit*, Fed. Res. Bull. 716 (Sept. 1979).

account parties, leaving about 0.03% as losses to the banks. 87/ Performance varied among the banks, with larger banks having a lower rate of drafts paid, but also having a lower recovery rate from account parties. 88/

The applicability of these figures to current standby letter of credit activity, particulaly with regard to publicly-offered securities, is limited, for several reasons. The volume of standby letters of credit issued by domestic banks has grown at least seven-fold since the survey was taken, from $25 billion in 1978 89/ to $175 billion in 1985. 90/ It appears that much of the growth has been in standby letters of credit backing financial obligations, which are regarged as involving a higher degree of risk than other obligations backed by standby letters of credit, such as bid and performance contracts. 91/ Also, recent intense competition in the financial guarantee market may have led some banks to guarantee less creditworthy parties. 92/ Finally, at the

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87/ Id. at 717. This loss rate compares favorably with a loan loss rate of 0.41 percent at the same banks. Id.

88/ Id.

89/ Id. at 716.

90/ Chessen, supra note 52, at 12.

91/ See Chessen, supra note 52, at 13; Johnstone and Mayher, supra note 82, at 14.

92/ See Chessen, Standby Letters of Credit, Recent Legis. and Other Dev. Impacting Depository Institutions 11 (Oct. 1985).

time the survey was performed, many of the credits had been outstanding only a relatively short time, and thus defaults by the primary obligors were less likely to have occurred. 93/

93/ *See id*.

B. Insurance Activity in the Financial Guarantee Market

During the 1970's, when many banks suffered financial difficulties and lost their high credit ratings, insurance companies began to issue policies that guaranteed debt securities. 94/ This section describes financial guarantee insurance and state regulation of that business, and provides statistical data on financial guarantee insurance.

1. Financial Guarantee Insurance

Financial guarantee insurance guarantees financial obligations, typically the payment of principal and interest by a debtor. Insurance companies entered the financial guarantee market with municipal bond insurance. 95/ More recently, financial guarantee insurance has been used to insure a variety of riskier obligations, including corporate bonds, installment purchase agreements, and structured financings. 96/

94/ Morrissey & Marino, Firemark Insurance Industry Commentary - Financial Guarantee Update 5 (1986).

95/ The origins of financial guarantee insurance have been traced to surety bonds and mortgage guarantee insurance, two traditional lines of insurance. Insurance Information Institute, Financial Guarantee Insurance 7-8 (1986). In the 1930's, mortgage guarantee insurers were liquidated when they defaulted on policies guaranteeing mortgages that were sold singly and in pools. These insurers failed for a number of reasons, including inadequate aggregate capital and surplus. See Report of the Moreland Commission to the Governor of New York (1934).

96/ See Model Bill Memo accompanying the National Association of Insurance Commissioners Financial Guarantee Insurance Model Bill (discussed in detail infra pp. 41-46) ("Model Bill Memo") at 16; Commission hearing at 18 (statement of Corcoran); U.S. General Accounting Office Staff Study, Financial Services - Developments in the Financial Guarantee Industry 19 (1987).

Financial guarantee insurance differs from most traditional insurance products. Traditional insurance coverage provides protection by spreading the risk among a large pool. While the number of claims against an insurer may be large, generally they are for relatively small amounts. 97/ By contrast, fewer claims are expected against financial guarantee insurance, but a claim may represent a substantial financial loss. 98/ Moreover, given the limited history with this type of insurance, actuarial projections may not be reliable. 99/

In deciding whether to issue a financial guarantee, insurers generally assess the likelihood of a claim on a "zero risk" or "no-risk" basis, rather than using actuarial assumptions about future claims. 100/ The insurer determines whether the potential client is capable of making principal and interest payments throughout the life of the obligation. In addition, to avoid the risk of loss against any unanticipated events, the insurer requires

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97/ Morrissey & Marino, supra note 94, at 6-7.

98/ Model Bill Memo at 13; Commission hearing at 20 (statement of Corcoran).

99/ Commission hearing at 17 (statement of Corcoran). Moreover, in contrast to other forms of insurance, profitability in the financial guarantee insurance industry depends not only on good underwriting, but also on a sound economy. Commission hearing at 20 (statement of Corcoran).

100/ Commission hearing at 42-43 (statement of W. James Lopp, Chairman and President, Financial Security Assurance Inc.).

other levels of protection, such as bank standby letters of credit or the pledging of marketable securities or physical assets. 101/

Financial guarantee insurance policies usually state that they "irrevocably and unconditionally" guarantee the payment of principal and interest during the term of the bond they are insuring, or that the policies are non-cancellable. 102/ Commentators indicated that under these policies an insurer would not be able to assert successfully any defense against a claim by a bondholder in the event of default by the issuer. 103/

Commentators specifically indicated that the defense of fraudulent inducement of a policy by the issuer is not available to a financial guarantee insurer. The only exception is the unlikely

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101/ Financial Security Assurance letter at 7. Because they only insure obligations that they believe are investment grade, and because of the additional protections they require, financial guarantee insurers contend that they provide credit enhancement, not credit substitution. *Id.* at 10.

102/ Financial Security Assurance letter at D-8 (sample surety bond); Satz, *Municipal Bond Insurance*, Advanced Municipal Bonds 1985, at 173 (sample insurance policy).

103/ *See* Commission hearing at 42, 55 (statements of Lopp and Richard Weill, Counsel to Financial Security Assurance); Bond Investors Guaranty letter at 2; letter from Stephen D. Cooke, First Vice President-Government and Regulatory Affairs, AMBAC, Inc. to Jonathan G. Katz, Secretary, SEC, dated March 13, 1987, at 2. *See generally* Financial Security Assurance letter at 11. However, the Commission is not aware of any case in which a court has ruled on this issue.

circumstance where a bondholder knew of or participated in the fraud on the insurer. 104/

Another insurance product used to provide credit enhancement for debt securities is a guaranteed investment contract ("GIC"). Most GICs are deferred annuities issued by insurance companies under which the purchaser agrees to pay money to an insurer (either in a lump sum or installments), and the insurer promises to pay interest at a guaranteed rate for the life of the contract. By receiving backing from GICs for taxable municipal bond issues, municipalities are able to secure high ratings for their bonds.

104/ See Commission hearing at 55-56 (statement of Weill); Bond Investors Guaranty letter at 2 and attached Mudge Rose Memorandum (analyzing the question under Article 8 of the Uniform Commercial Code, contract law principles affecting third party beneficiaries, and suretyship law).

There are, however, at least two cases in which insurers that issued policies in connection with securities are refusing to pay investors on the ground that the policies were procured by fraud. One Pennsylvania financial guarantee insurer has refused to pay claims arising from limited partnerships it guaranteed, contending it was defrauded by managing general agents. See Commission hearing at 19 (statement of Corcoran).

The other instance involves EPIC Mortgage Inc., which sold mortgages and mortgage-backed securities now in default. Some of EPIC Mortgage's mortgage insurers have sought rescission of the mortgage insurance contracts, contending that EPIC, which purchased the insurance, defrauded the insurers. See Joint Memorandum of Law In Support of Motion for Partial Summary Judgment at 1-2, In re EPIC Mortgage Insurance Coverage Litigation, M.D.L. No. 680 (E.D. Va. Multi-District Litigation ordered April 11, 1986); see also Monroe, Role of Insurers of Securities is Focus of Suits, Wall St. J., Jan. 20, 1987 at 37, col. 3.

While GICs are similar to financial guarantee insurance in that both enhance the credit rating of the security, thereby lowering the cost of financing for the issuer, a GIC is not a true guarantee. A GIC is a primary obligation to make payments, whereas a guarantee involves a secondary obligation which arises only upon the default of the primary obligor. 105/ Because of this, GICs have been likened to a strong commercial enterprise underlying a municipal bond issue. 106/

2. State Regulation

The insurance industry is regulated primarily by the states. 107/ For the most part, states have not developed specific regulation for financial guarantee insurance. 108/ Recently, however, the National Association of Insurance Commissioners (NAIC) has adopted

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105/ In this regard, the National Association of Insurance Commissioners' Model Financial Guarantee Insurance Act, discussed *infra* pp. 41-46, specifically excludes GICs from its coverage. Model Act Section 1(A)(2)(j).

106/ *See* letter from Frederick T. Croft, Vice President, Van Kampen Merritt Inc., to Jonathan G. Katz, Secretary, SEC, dated March 4, 1987, at 3 ("Van Kampen Merritt letter").

107/ The McCarran-Ferguson Act, 15 U.S.C. 1011-15, provides that no act of Congress shall be construed to invalidate, impair or supersede any law enacted by any state for the purpose of regulating the business of insurance, unless such act specifically relates to the business of insurance. The Act does not preclude the Commission, however, from administering the federal securities laws with respect to a security simply because the security is promoted or issued by an insurance company. *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969).

108/ Morrissey & Marino, *supra* note 94, at 23.

model financial guarantee insurance legislation. 109/

Because there is no specific regulation for financial guarantee insurance, currently it is written as surety, inland marine, or credit insurance, under regulations for those types of insurance. 110/ The companies that write this insurance are regulated by the states' general insurance laws. Generally, these laws require the filing of quarterly and annual financial statements, and impose restrictions as to policy forms and premium rates. 111/

The only existing specifically tailored financial guarantee regulation is for municipal bond insurance. California, Illinois, New York, and Wisconsin have adopted laws or regulations to regulate municipal bond insurance. 112/ These provisions generally define

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109/ The NAIC's membership consists of 55 Insurance Commissioners from the fifty states and the District of Columbia, Guam, American Samoa, the Virgin Islands, and Puerto Rico. The NAIC meets twice a year and forms task groups to study various topics and create model insurance regulations.

110/ Commission hearing at 19-20 (statement of Corcoran).

111/ Recently, the NAIC approved an amendment to the annual statement instructions for insurers. The amendment categorizes financial guarantee insurance into four types and requires the disclosure of aggregate exposure as to each type. The instructions were amended to conform to the definition of financial guarantee insurance in the NAIC model legislation. These four categories are municipal bond insurance, secured corporate obligations, unsecured corporate obligations, and all other guarantees (generally including guarantees of financial or economic risks). NAIC Proc. - 1986, Vol. II at 255, 279-80.

112/ See Cal. Ins. Code §§ 12100-12109 (1985); Ill. Admin. Reg. Part 205.20 - 205.90; N.Y. Admin. Code Tit. 11, Chap. III Part 63 (Reg. 61) (1980); Wisc. Admin. Code § Ins. 3.08 (1985).

municipal bond insurance; 113/ establish paid-in capital, surplus, and contingency reserve requirements; 114/ and impose single and aggregate risk restrictions and unearned premium 115/ and loss reserves. 116/

In 1985, the NAIC created a study group on financial guarantee insurance. Because of the rapid growth of financial guarantee insurance, the apparent risk of the industry, and the inadequacy of current legislation, the NAIC perceived a need to develop legislation to avert potential crises. 117/ In 1986, the study group submitted a proposed Model Financial Guarantee Insurance Act to the NAIC membership, which adopted the Model Act

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113/ In these regulations, municipal bond insurance is commonly defined as "insurance against financial loss by reason of nonpayment of principal, interest, or other payment obligations pursuant to the terms of municipal bonds." Cal. Ins. Code § 12100(a).

114/ A contingency reserve has been defined as "a reserve established for the protection of policyholders covered by policies insuring municipal bonds against the effect of excessive losses occurring during adverse economic cycles." Wisc. Admin. Code § Ins. 3.08(3)(b).

115/ An unearned premium reserve represents premiums on unexpired coverage; in other words, prepaid premiums which are "earned proportionally with the expiration of exposure." Wisc. Admin. Code § Ins. 3.08(8).

116/ A loss reserve is for "losses and loss adjustment expenses for claims reported and unpaid * * *." Ill. Admin. Reg. Part 205.60(b).

117/ NAIC Proc. - 1986, Vol. II at 209. For example, regulators were concerned about the lack of information on the amount and type of obligations being guaranteed. Commission hearing at 16 (statement of Corcoran, chairman of the study group).

on June 12, 1986. 118/ The Model Act defines financial guarantee insurance, limits writing financial guarantee insurance to mono-line companies (companies that engage in only one line of business), 119/ establishes single and aggregate risk limits and contingency reserve requirements, and excludes financial guarantee insurance from state guaranty or insolvency funds. 120/

The Model Act defines financial guarantee insurance to include guarantees of indebtedness on which principal and interest may be guaranteed. 121/ Several insurance products, including traditional

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118/ NAIC Proc. 1986-Vol. II at 219-27. The Model Bill and Model Bill Memo were amended December 9, 1986. NAIC Proc. 1987-Vol. I at 166-74. All references in this report are to the Model Bill and Model Bill Memo as amended December 9, 1986.

119/ The Model Act allows for a phase-in period during which a multiline insurer can either cease writing new business and reinsure its financial guarantee business with a financial guarantee insurance corporation, or form a subsidiary to carry on its financial guarantee business. Section 3(G).

120/ Guaranty funds vary from state to state, but generally they are funded through assessments on insurance companies authorized to transact business within a state. These funds are used to pay claims of insureds that are not paid when an insurer becomes insolvent. See, e.g., NAIC Post-Assessment Property and Liability Insurance Guaranty Association Model Act § 2. Generally, these funds are post-assessment funds. That is, the fund assesses domiciled insurers a percentage of written premiums to pay for claims of insurers that have been declared insolvent.

121/ Model Act Section 1(A)(1). The Act also defines financial guarantees to include guarantees against financial or economic risk, such as guarantees against changes in the levels of interest rates or rates of currency exchange. However, the Act prohibits the writing of such insurance. These risks are not considered insurable since there is no spreading of the risk, as a loss due to an economic downturn could affect a large number of insurers at one time. See Model Bill Memo at 21.

surety, residual value, mortgage guaranty, credit unemployment insurance, 122/ and guaranteed investment contracts, are not treated as financial guarantee insurance under the Act, although they may technically fall within the definition of financial guarantee insurance. 123/ The Act allows a financial guarantee insurance corporation to sell only financial guarantees of indebtedness, plus surety, credit, and residual value insurance. 124/ The types of indebtedness for which policies can be written include municipal, special revenue, industrial development, or corporate bonds, limited partnership obligations, certain pass-through securities, installment purchase agreements, and consumer debt obligations. 125/

The NAIC Model Act prohibits multiline property and casualty insurers from writing financial guarantee insurance. The NAIC commentary to the Act identifies a number of reasons for this prohibition. They include the potential to bankrupt the company, or limit its ability to write more essential lines of insurance; the burden on the guaranty fund; reporting problems; 126/ diverting

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122/ Credit unemployment insurance is purchased by a debtor in connection with a specific debt to provide payments to a creditor for any period the debtor is unemployed. See Model Act Section 1(A)(2)(h).

123/ Model Act Section 1(A)(2)(a)-(n).

124/ Model Act Section 2(A).

125/ Model Act Section 3(B)(1).

126/ Reporting problems include the difficulties of determining the risks incurred or the capital supporting the business, and of separating, as to each line of business, the premiums, total exposure, underwriting experience and types of guarantees covered. Model Bill Memo at 18.

limited multiline capacity to write insurance from more essential lines of insurance; the perceived lack of expertise to write financial guarantee insurance; and the added difficulty of regulating financial guarantee insurance when it is written by a multiline insurer. 127/

The Act subjects financial guarantee insurance corporations to those general insurance laws that are not in conflict with the Act. It sets forth procedures for the organization of financial guarantee insurance corporations, including the submission of a plan of operation to the state insurance commissioner. 128/ The Act specifies minimum financial requirements of organizing a covered insurance company, including paid-in capital, paid-in surplus, and minimum policyholders' surplus requirements. 129/ The Act requires a contingency reserve for excessive losses computed according to the riskiness of the obligations guaranteed; municipal bonds are considered the least risky. 130/ The Act also requires loss reserves, for claims reported but unpaid, 131/ and unearned

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127/ Model Bill Memo at 17-20.

128/ Model Act Section 2(A)(3), (4).

129/ Model Act Section 2(B)(1). A policyholders' surplus is generally defined as "an insurer's net worth, the difference between its assets and liabilities, as reported in its annual statement." *See, e.g.*, Wisc. Admin. Code § Ins. 3.08(3)(i).

130/ Model Act Section 2(B)(2).

131/ Model Act Section 2(B)(3).

premium reserves, which allow premiums to "be earned proportionately with the expiration of exposure". 132/

In addition, the Act establishes aggregate risk limits, which require an insurer to maintain an aggregate capital, surplus, and contingency reserve determined as the sum of a percentage of the total liability for each type of obligation insured. 133/ The Act also places single risk limits on a corporation's exposure to loss on the guarantees of the obligations of a single entity, which is computed as a percentage of the insurer's aggregate capital, surplus, and contingency reserve. 134/

132/ Model Act Section 2(B)(4).

133/ Model Act Section 3(D). These percentages include .2857% for municipal bonds, .5714% for special revenue bonds, 1% for industrial development bonds and most secured corporate obligations which are investment grade, 4% for other investment grade obligations and consumer debt, 10% for non-investment grade obligations other than consumer debt, and an amount determined by the state insurance commissioner for surety, residual value, and credit insurance. Whether an obligation is "investment grade" is determined either by a credit rating agency acceptable to the commissioner or by the Securities Valuations Office of the NAIC. Model Act Section 1(J).

134/ Model Act Section 3(E). The Model Act also regulates reinsurance. In reinsurance, the original insurer cedes to another insurance company (the reinsurer) all or a portion of its risks for a stated percentage of the premium. 19A Appleman, Insurance Law and Practice § 7681 (1982). The reinsurer is liable only to the ceding company, which retains all contact with the original insured. Id. Under the Model Act, only three types of insurers may write this reinsurance business, including a financial guarantee insurer. The reinsurer may not be an affiliate of the guarantor or, if it is, it may not assume liability that is greater than its equity interest in the guarantor. Additionally, the reinsurance agreement cannot be cancelled or amended except by the ceding insurer, or, if it is insolvent, by the Commissioner of Insurance. Model Act Section 5.

The Model Act excludes financial guarantee insurance corporations from the state guaranty or insolvency funds, and requires them to state this on any policies or advertisements. 135/ The memorandum accompanying the Model Act indicates that this exclusion is needed to ensure that purchasers of financial guarantee insurance not rely on the fund, but instead carefully examine the insurer's ability to meet its obligations, thereby imposing a form of market discipline on this industry. 136/ There is also a concern that, if the guaranty fund had to pay each investor in the event of a bond default, the cost to the fund could be enormous. 137/

The Model Act has not yet been adopted by any state. A bill patterned after it has recently been introduced before the legislature of the State of New York. 138/ Other states may be waiting until New York acts on the proposed legislation. 139/

135/ Model Act Section 3(B)(2).

136/ Model Bill Memo at 21.

137/ *Id.* at 21-22. Also, other insurance companies, which have chosen not to take the risks of financial guarantee insurance, have stated that they do not want to pay insolvency fund assessments on the covered losses of those who choose to take the risks. NAIC Proc. - 1986, Vol. I at 162 (statement of William J. Murray, Vice President and Counsel, Chubb & Son Inc.).

138/ Commission hearing at 20 (statement of Corcoran). In 1986 two bills were presented before the New York legislature on financial guarantee insurance. One was based on the Model Act, while the other would have allowed multiline companies to sell financial guarantees. Neither bill, however, was enacted.

139/ Commission hearing at 29 (statement of Corcoran); Morrissey & Marino, *supra* note 94, at 23. The response of insurers to the Model Act is mixed. Some multiline companies would like to continue writing this type of insurance. They argue

(footnote continued)

3. Statistical Data on Financial Guarantee Insurance

Because of the lack of regulation of financial guarantee insurance, there is little statistical information regarding the activities of financial guarantee insurers of corporate debt. The exact amount of financial guarantee insurance being sold is unknown because it is generally reported on company records as "miscellaneous surety." 140/ This miscellaneous category increased 50% in 1984, compared to an increase of 2% for contract bond insurance, a traditional type of surety. 141/

More information is available on the activities of the municipal

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139/ (footnote continued)

that segmented and separate reporting, what they view as a limited potential for risk, and exclusion of financial guarantee insurance lines of business from state guaranty funds make it unnecessary to exclude multiline insurers. NAIC Proc. - 1986, Vol. I at 160-61 (statement of The Travelers). Other multiline insurers believe it is appropriate to limit the business to monoline companies because it would insulate the business from potentially enormous losses, keep other insurers from having to pay guaranty fund assessments for losses incurred by financial guarantee insurers, and allow for a more accurate evaluation of the strength of the guarantee. Id. at 162 (statement of William J. Murray, Chubb and Son Inc.).

Monoline insurers presently issuing financial guarantees appear to be generally in favor of the Model Act. Financial Security Assurance letter at 14.

140/ U.S. General Accounting Office Staff Study, supra note 96, at 6-7. As discussed supra note 109, the NAIC recently has amended its instructions to the annual reports of issuers which require detailed reporting of financial guarantee activity. Accordingly, more data should become available.

141/ Brenner, Booming Financial Guarantee Market Generates Profits - and Some Questions, Am. Banker, June 24, 1985, at 1, 18.

bond insurers. Recently, it was estimated that municipal bond insurers had a current exposure to losses of approximately $300 billion. 142/ Three of the larger insurers have reported no claims. 143/ However, another large insurer, AMBAC, Inc., has paid at least twenty claims, the largest of which relates to the Washington Public Power Supply System ("WPPSS") default, for which its aggregate exposure is $75.5 million. On the WPPSS claims, AMBAC will pay $2 million annually through 2007, and from 2008 to 2018 it will pay $[illegible] million annually. 144/

AMBAC has also paid claims resulting from four industrial revenue bond issue defaults in Tennessee and Georgia, with an aggregate par value of $79 million. 145/ As a result, AMBAC's ability to write new business has been curtailed, although its high credit rating remains intact.

Other insurers have experienced drops in their credit ratings,

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142/ The Risky Business of Insuring Muni Debt, Bus. Wk., Apr. 27, 1987, at 96.

143/ The four insurers that dominate the municipal bond insurance market are Municipal Bond Insurance Association ("MBIA"), Financial Guaranty Insurance Corp., AMBAC, Inc., and Bond Investors Guaranty, Inc. These four firms accounted for 96.9% of the municipal bond insurance sold in 1985. Financial Security Assurance letter at 17.

144/ Financial Security Assurance letter at 18. AMBAC has reserved $2[illegible].5 million to cover its WPPSS obligations. Id.

145/ Shea, Tenn. Developer May Default on Memphis Hotel, IRBs, Issuer Says, Bond Buyer, Sept. 16, 1986, at 1. There have also been losses on financial guarantees involving mortgages. Fireman's Fund issued two policies for $6 million each on a trust deed investment program. Investors invested $55 million in this program. When Fireman's Fund refused to renew the policies the company filed a petition under Chapter 11 of the Bankrupty Code. The investors sued Fireman's Fund,

(footnote continued)

leading to declines in the prices of bonds they insured. Industrial Indemnity Insurance Company, a multiline insurer, suffered losses in other areas of its business, and had its claim paying rate dropped from AAA to AA. Two hundred and sixty bonds it insured totaling $5.2 billion in principal were affected, and the company is no longer selling financial guarantees. 146/ Similarly, U.S. Fidelity & Guaranty Co. was downgraded from AAA to AA because of losses in its other insurance lines. Seventy-three tax exempt bond issues it insured, totaling over $1 billion in principal, fell in price. 147/

145/ (footnote continued)

which eventually settled the claims for $55 million, in exchange for an interest in the mortgage trust deeds underlying the program. Freedman, *supra* note 10, at 20.

Glacier General Assurance Co., which is now insolvent, and Pacific American Insurance Co. suffered financial problems when the land values of property underlying a mortgage pool they were insuring were determined to be inflated. Financial Security Assurance letter at 18; Brenner, *supra* note 139, at 15. Another company selling mortgage insurance, Cal-Farm Insurance Co., was placed in conservatorship, after $60 million of bonds it guaranteed went into default. Financial Security Assurance letter at 18.

146/ Morrissey & Marino, *supra* note 94, at 11.

147/ *Id.*; *The Risky Business of Insuring Muni Debt*, Bus. Wk, Apr. 27, 1987, at 96-97; *Faces Behind the Figures*, Forbes, Aug. 10, 1987, at 112.

C. The Role of Credit Rating Agencies

The primary reason an issuer purchases a guarantee is to lower borrowing costs by increasing the apparent safety of a security. 148/ Accordingly, the private organizations that rate the soundness of debt issues play a major role in the financial guarantee market.

1. The Credit Rating Agencies

Five major rating organizations provide public ratings on debt securities. Standard & Poor's Corporation, Moody's Investor Service, and Fitch Investors Service are the best known. More recently, Duff & Phelps, Inc. and McCarthy, Crisanti & Maffei, Inc. have begun to rate debt offerings. 149/

The public rating of a debt security is designed to enable investors to make informed decisions in assessing the probability

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148/ Similarly, sponsors of unit investment trusts that purchase guarantees of securities in the trusts' portfolios are seeking to raise the rating of the trust and thereby increase the attractiveness of the trust to investors. See supra note 10.

149/ See Fabozzi & Pollack (eds.), The Handbook of Fixed Income Securities 369-71 (1983); Insurance Information Institute, supra note 95, at 67-68. These five organizations are considered "nationally recognized statistical rating organizations" for purposes of Rule 15c3-1(c)(2)(vi)(F). See Investment Company Act Release No. 15314 (Sept. 17, 1986) at n.32. Recently a number of Japanese rating agencies have started to compete with the American agencies. The Big Two Bond Raters Do Battle Abroad, Bus. Wk., May 6, 1985, at 62.

In addition, the A.M. Best Company rates the financial strength of insurance underwriters. Best does not rate particular securities, however. See letter from John Grillos, Counsel, A.M. Best Company, to Jonathan G. Katz, Secretary, SEC, dated April 22, 1987, at 2; Adams, When is an 'A' Rating not an 'A'?, Forbes, Oct. 20, 1986, at 43; Snyder, Best's Ratings: A New Look, Best's Rev., Apr. 1986, at 14.

of timely repayment of interest and principal and the adequacy of protection in the event of credit difficulties such as bankruptcy or insolvency. 150/ Since the rating is also related to the anticipated performance of the issue in the secondary market, it has a considerable effect on the cost and marketability of public debt issues. 151/

Generally, the rating categories used by the various agencies, at least for investment grade securities, as well as the methodology, are similar. 152/ There are, however, several noteworthy differences. The fees charged for a rating vary considerably, although they

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150/ Zaitzeff, Foreign Bank Participation in the U.S. Capital Markets: A Legal Perspective, 2 Touro L. Rev. 19, 183 (1986); Irving Trust Co., The Rating of Corporate Debt Issues.2 (1973). See also Standard & Poor's, Debt Ratings Criteria: Industrial Overview 3 (1986); Fitch Investors Service, Inc., Corporate Rating Criteria ii (1986).

151/ Some investors are prohibited by law from investing in securities below a particular rating. See, e.g., 12 C.F.R. 545.72 (Federal Home Loan Bank Board rule requiring that thrifts invest in municipal debt obligations with investment grade ratings). Additionally, the lower the rating, the more difficult it is to find investors willing to accept the level of risk reflected in the rating. Rudnitsky, What's in a Rating?, Forbes, Sept. 12, 1983, at 41; Irving Trust Co., supra note 150, at 2; The Twentieth Century Fund, The Rating Game 46 (1974) ("Rating Game"); Ross, Higher Stakes in the Bond-Rating Game, Fortune, Apr. 1976, at 132.

152/ The four highest rating categories are as follows:

	S&P	Moody's	Fitch
Prime	AAA	Aaa	AAA
Excellent	AA	Aa	AA
Upper medium	A	A, A-1	A
Lower medium	BBB	Baas, Baa-1	BBB

(footnote continued)

are generally tied to the amount of the offering. 153/ After the initial rating, the issue is reviewed periodically during the life of the issue. 154/ All of the major agencies, except McCarthy, Crisanti & Maffei, meet with management prior to issuing a rating. Standard & Poor's, Moody's, and Fitch also question a company's management concerning its plans and forecasts. 155/

The final rating decision of an agency is a product of many factors, some of them subjective. 156/ In assessing the riskiness of a debt security, the agency investigates the company's management, level and stability of earnings, financial resources, asset

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152/ (footnote continued)

Duff & Phelps assigns numerical ratings from 1-14, with 1 equivalent to AAA. Fabozzi & Pollack, *supra* note 149, at 369-70. The agencies provide fuller descriptions of the meanings of the various ratings employed. *See* Standard & Poor's, *Debt Ratings Criteria: Industrial Overview* 10 (1986); Fitch Investors Service, Inc., *supra* note 150, at iv-v; Irving Trust Co., *supra* note 150 at 8-11; Rating Game, *supra* note 151, at 40; *see also* Best's Rev., Apr. 1986, at 125-26.

153/ *Bond Ratings: Which Do You Follow?* Bus. Wk., Apr. 12, 1982, at 112; Zaitzeff, *supra* note 150, at 184; Irving Trust Co., *supra* note 150, at 7; Fabozzi & Pollack, *supra* note 149, at 369; Bagamery, *The Gloom-and-Doom Boys*, Forbes, Mar. 12, 1984, at 93. McCarthy, Crisanti & Maffei does not charge the issuer a fee for a rating but rather earns fees solely from sale of its information and analyses. *Id.*

154/ Fabozzi & Pollack, *supra* note 150, at 369.

155/ Bagamery, *supra* note 153, Standard & Poor's, *Credit Overview: Corporate and International Ratings* 9-10 (1983); Fitch Investors Service, Inc., *supra* note 150, at iii.

156/ *See, e.g.*, Ross, *supra* note 151, at 136, 138 (subjective factors such as nature of the industry, quality of a company's earnings and assets, experience, and depth of management).

protection, and indenture provisions. 157/ The emphasis placed on each factor varies according to the type of debt and company, and from agency to agency. 158/ The agencies frequently do not agree on a rating for the same issue, due in part to the subjective nature of the rating process. 159/

The rating agencies have been criticized on the ground that the rating categories are too broad. 160/ They also have been criticized for their slow response to changes in an issuer's credit condition. Indeed, the market generally anticipates credit rating changes. 161/

The historical experience of defaults of bonds with different

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157/ Irving Trust Co., *supra* note 150, at 3.

158/ Irving Trust Co., *supra* note 150, at 4. For example, when rating long-term debt, particular emphasis is placed on the relationship between the level and stability of future earnings and the total outstanding long-term debt. *Id.* The company is also compared with industry norms for each rating level.

159/ *See* Bagamery, *supra* note 153; Perry, *The Effect of Bond Rating Agencies on Bond Rating Models*, 8 J. of Fin. Research 307, 313 (1985) (Moody's and S&P's disagreed 58% of the time); Bus. Wk., Apr. 12, 1982, *supra* note 153; *cf.* Cluff & Farnham, *Standard & Poor's vs. Moody's: Which City Characteristics Influence Municipal Bond Ratings?*, 24 Q. Rev. of Econ. & Bus. 72, 89 (1984) (concluding that S&P's and Moody's appear to use a different set of factors in developing a municipal bond ratings); Fabozzi & Pollack, *supra* note 149, at 390-95.

160/ Fabozzi & Pollack, *supra* note 149, at 370; Rating Game, *supra* note 151, at 3.

161/ Fabozzi & Pollack, *supra* note 149, at 370; Hettenhouse & Sartoris, *An Analysis of The Informational Value of Bond-Rating Changes*, Q. Rev. of Econ. & Bus. 65, 76 (Summer 1976). Since the agencies' obligation is to rate long-term debt, however, they purposely do not change a rating because of short-term fluctuations. Fabbozzi & Pollack, *supra* note 149, at 370; Fitch Investors Service, Inc., *supra* note 150, at I-2.

ratings indicates that the highest rating category has been quite reliable. An early study of defaults of corporate bonds from 1900-1943 found a total default rate of 17.3%, but only 5.9% for securities rated AAA at the time they were issued. 162/ This and other studies suggest that the bond rating agencies have been relatively successful over long periods of time in assessing credit risk. 163/ A recent study of default rates for debt issued between 1971 and 1985 shows a zero default rate during that period for AAA rated corporate debt. 164/

The apparent accuracy of the rating agencies in designating a AAA or "prime" rating has made the AAA rating an attractive and generally reliable indicator of credit risk for the investor. 165/ The AAA rating is particularly important in attracting investors in the aftermath of investor losses from recent well-publicized failures such as the Washington Public Power Supply System

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162/ W. Hickman, Corporate Bond Quality and Investor Experience 10 (1958).

163/ Tinic & West, Investing in Securities: An Efficient Markets Approach 360 (1979).

164/ Altman & Nommacher, Investing in Junk Bonds 131 (1987). This study covers only a period of 15 years. Given the long terms typical of these bonds, frequently as long as 20 or 30 years, default experience over the life of the bonds may be higher.

165/ Those entities rated AAA form an exclusive group. For example, excluding the financial guarantee marketplace, Standard & Poor's rated only 14 industrial companies and one domestic bank as AAA on their public senior debt in 1986. Insurance Information Institute, supra note 95, at 69-70.

and the New York City debt crisis. 166/ And, as noted, there are corresponding borrowing savings to a company with a AAA rated issue. 167/

Because of the significance of credit ratings, entities seeking public financing have sought to utilize various forms of "credit enhancement" to boost their credit rating. For example, if a bond issue is guaranteed by a more creditworthy parent company or by a standby letter of credit of a highly rated bank, the rating agencies raise the rating (although not necessarily to the same level as the guarantor). 168/ These credit enhancement devices, whether in the form of standby letters of credit or financial guarantee insurance, enable the entity seeking financing to "borrow" the credit rating of the guaranteeing entity. 169/

2. How Guaranteed Securities Are Rated

When a bond offering is supported by a standby letter of credit or a financial guarantee insurance policy, the rating generally

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166/ Rudnitsky, *supra* note 151, at 41; Standard & Poor's, *Debt Ratings Criteria: Municipal Overview* 143 (1986); Neubecker, *What's Behind the Bittersweet Boom in Financial Guarantees*, Bus. Wk., Sept. 17, 1984, at 116.

167/ For example, in the municipal market, the interest costs for an AA-rated issue are about one-third of a percentage point more than for an AAA-rated issue, a single-A three-quarters of a percentage point more. Bus. Wk., Apr. 12, 1982, *supra* note 153; *see* Standard & Poor's, *Debt Ratings Criteria: Municipal Overview* 143 (1986).

168/ Irving Trust Co., *supra* note 150, at 4.

169/ Zaitzeff, *supra* note 150, at 183; Fabozzi & Pollack, *supra* note 149, at 398; Rudnitsky, *supra* note 151, at 41. *But see* Fabozzi & Pollack, *supra* note 149, at 394 (Moody's assigns insured municipal bond credit ratings on the basis of the underlying merits of the bond).

will be based on the credit strength of the supporting institution and its credit rating. 170/ In rating the guarantor, the rating agencies look to such factors as capital adequacy, management structure, and underwriting practices. 171/

Standard & Poor's has explained in detail its methodology in rating companies that issue financial guarantee insurance. 172/ Originally, Standard & Poor's used a model based on municipal defaults during the Great Depression to determine the amount of capital necessary to meet periods of economic stress. 173/ Under this model, to receive the highest rating a guarantor had to have sufficient capital to meet a worst-case default rate of 10%.

170/ Freedman, *supra* note 10, at 16; Insurance Information Institute, *supra* note 95, at 71. Standard & Poor's rates bank-supported municipal debt solely on the basis of the creditworthiness of the bank. If the bondholder can look to the bank for timely repayment of principal and interest, the debt is rated equal to the bank. Standard & Poor's, *Debt Ratings Criteria: Municipal Overview* 113 (1986). Similarly, its ratings of insurance-supported municipal bonds are based primarily on the creditworthiness of the insurers. *Id.* at 143.

171/ *See, e.g.*, Standard & Poor's, Credit Week, Aug. 5, 1985, at 13. *See generally* Standard & Poor's, *Corporate Bond Ratings* (1978); Insurance Information Institute, *supra* note 95, at 67-82; Snyder, *supra* note 149, at 14.

172/ Insurance Information Institute, *supra* note 95, at 67-82; Standard & Poor's, *Debt Ratings Criteria: Municipal Overview* 143-49 (1986). *See also* Standard & Poor's, Credit Week, Aug. 5, 1985, at 13. The other rating organizations have not disclosed in detail their methods.

173/ Insurance Information Institute, *supra* note 95, at 73-74.

Applying this model, Standard & Poor's issued its first financial guarantee insurance rating in 1971 to AMBAC.

The usefulness of this model based on Depression municipal defaults has diminished in the current market. Consequently, Standard & Poor's has developed its own capital adequacy model for municipal bond insurers. 174/ The model assumes that the company's portfolio of insurance policies back debt that was investment grade (BBB or higher) at the time of purchase, and identifies more than 20 risk-categories of municipal debt. The capital levels for each category needed to meet a worst-case economic depression are correlated to both the amount of principal and interest insured and to the degree of risk being insured. 175/

Although Standard & Poor's commenced rating financial guarantee insurance companies that insure primarily taxable securities in 1985, it has not yet fully refined a specific segment risk model for this type of company. 176/ In developing its first rating of this type for Financial Security Assurance, it assumed a worst case default rate for taxable risks of 45% (about 300% of the 16% worst

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174/ The current mix of municipal financing includes obligations, such as hospital and nuclear facility debt, where both the default rate and duration of default are considered to be higher than with the general bond obligations of the Depression era. Insurance Information Institute, *supra* note 95, at 74.

175/ Insurance Information Institute, *supra* note 95, at 76. The peak cumulative debt service guidelines range from a low of 3% for state-backed general obligations to a high of 40% for public power agency nuclear projects. *Id.* at 75.

176/ Standard & Poor's, Credit Week, Aug. 5, 1985, at 13.

case default rate for municipal bonds). 177/ Standard & Poor's anticipates developing specific-risk models for the corporate and taxable business in the near future. 178/

In the case of a multiline insurance company, Standard & Poor's analyzes its traditional and financial guarantee businesses separately because of the recent rapid growth in the latter and because the customary method of assessing capital adequacy is inappropriate. 179/ For a multiline company to receive a AAA rating, both the traditional and financial guarantee business should be AAA. 180/ The rating of an issue insured by a multiline company is based on the rating of the entire company, not just the financial guarantee segment of the company. 181/ Where the guarantor is a consortium of several companies (such as Municipal Bond Insurance Association), each of the members must be rated AAA for the guarantor to receive a AAA rating.

177/ Id. The appropriateness of this assumption may be further eroded by the recent phenomenon of the use by solvent corporations of bankruptcy as a strategy to avoid, for example, labor or supply contracts or the possibility of large legal judgments. Standard & Poor's, Debt Ratings Criteria: Industrial Overview 39 (1986).

178/ Insurance Information Institute, supra note 95, at 74; Standard & Poor's, Credit Week, Aug. 5, 1985, at 13.

179/ Insurance Information Institute, supra note 95, at 77; Standard & Poor's Debt Ratings Criteria: Municipal Overview 146 (1986). But see Commission hearing at 18 (statement of Corcoran).

180/ Insurance Information Institute, supra note 95, at 77.

181/ Id. at 80. In arriving at its rating, Standard & Poor's indicates that it does not analyze each underlying issue insured, although it also states that it does analyze all surety bonds. Id at 80-81.

In rating a monoline financial guarantee company, Standard & Poor's constructs a rating profile for the firm. 182/ Standard & Poor's analyzes not only the firm's ability to meet a depression scenario, but also examines six key factors: management; capital (primary capital of at least $150 million plus $50 million of reinsurance); underwriting practices (insured municipal business should be investment grade, with diversified risk, and attention to liquidity risks due to possible acceleration); income; reinsurance; and the insurance policy (must be unconditional and irrevocable). Standard & Poor's analyzes the creditworthiness of each issue insured and, over time, monitors the monoline company's portfolio, requiring either additional capital or a reduction in rating if significant deterioration in its credit quality occurs. 183/

The rating agencies also rate banks, both domestic and foreign, and bond issues backed by their standby letters of credit. 184/ In analyzing a bank's capital, risks arising from off-balance sheet contingencies such as standby letters of credit must be included. Standard & Poor's approach is to add outstanding letters of credit to the total loans, although in 1983 it indicated that only a few

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182/ Standard & Poor's, Debt Ratings Criteria: Municipal Overview 146 (1986).

183/ Insurance Information Institute, supra note 95, at 80. Three of the four major municipal bond issuers are monoline companies; most of the insurers of other types of bonds are multiline companies. Haine, Developments in Financial Guarantee Insurance, Bus. Law. Update, Nov.- Dec. 1986, at 6.

184/ See generally Standard & Poor's, Credit Overview: Corporate and International Ratings 46-51, 61-64, 76-77 (1983); Zaitzeff, supra note 150, at 183-88.

banks had issued sufficient letters of credit to affect their capital ratios. 185/ As in the case of issues backed by insurance company guarantees, the approach in rating those issues is to analyze the structure of the financing and the creditworthiness of the bank. The creditworthiness of the issuer generally is not examined. 186/

185/ Standard & Poor's, Credit Overview: Corporate and International Ratings 48 (198[illegible]).

186/ Id. at 61. As discussed supra note 101, financial guarantee insurers contend that they insure only investment grade obligations.

IV. THE TREATMENT OF FINANCIAL GUARANTEES UNDER THE SECURITIES ACT

The financial guarantee activities of banks and insurance companies are treated differently under the Securities Act. Under the Act, public offerings of securities must be registered in accordance with Section 5 of the Act unless an exemption is available. Under Section 2(1) of the Securities Act, a guarantee of a security is a separate security. Thus, the guarantee also must be registered unless an exemption is available. Financial guarantees in the forms of bank standby letters of credit and insurance policies have generally not been registered, in reliance on the exemptions in Sections 3(a)(2) and 3(a)(8) of the Act, respectively. The underlying securities guaranteed by banks are also exempt from registration under Section 3(a)(2), but securities guaranteed by insurance are not.

A. Financial Guarantees Issued by Banks

1. Domestic Banks

Financial guarantees issued by domestic banks in the form of standby letters of credit are exempt from registration pursuant to Section 3(a)(2) of the Securities Act, which exempts "any security issued * * * [by] any national bank, or any banking institution organized under the laws of any State, Territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official * * *." In addition, Section 3(a)(2) exempts from registration "any security

* * * guaranteed by" such a bank. Since standby letters of credit are "tantamount to guarantees by [a] bank," securities backed by those letters of credit also do not have to be registered. 187/ Thus, both the security backed by the letter of credit and the letter of credit are exempt from registration under the Securities Act. 188/

2. Foreign Banks

For more than twenty years, the Commission's Division of Corporation Finance and the Commission addressed the applicability of Section 3(a)(2) to securities issued or guaranteed by domestic branches and agencies of foreign banks through no-action positions, and later through an interpretive release. Beginning in the

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187/ Merrill Lynch, Pierce, Fenner & Smith, Inc. (Division of Corporation Finance no-action letter avail. May 3, 1982) For other purposes, a standby letter of credit may be deemed not to be a guarantee but rather an "engagement * * * [of] the issuer [to] * * * honor drafts or other demands for payment upon compliance with the conditions specified. " UCC § 5-103.

188/ The legislative history of the exemption in Section 3(a)(2) for securities issued or guaranteed by banks is limited. The House report on the bill that served as a basis for the Securities Act indicated that the exemption was based on a belief that bank regulatory authorities exercised "adequate supervision over the issuance of [bank] securities." H.R. Rep. No. 85, 73d Cong., 1st Sess. 14 (1933). Some commenters suggested that this statement indicates that the banking regulatory structure in 1933 provided safeguards that obviated the necessity for the protections of the Securities Act. See American Bankers Association letter at 4; First Interstate Bankcorp letter at 2; New York Clearing House letter at 9.

It has also been suggested that the exemption was enacted based on the mistaken belief that banks would be required to file material similar to a registration statement with bank supervisory authorities. This suggestion is based on the

(footnote continued)

1960's, the Division and, in two instances, the Commission determined in a series of no-action positions that foreign and domestic banks should have the same privileges and be subject to the same rules in this country, in part as a policy of "national treatment." 189/ Thus, the Commission and Division indicated that securities issued or guaranteed by domestic branches and agencies of foreign banks were deemed to be within Section 3(a)(2), in light of the domestic regulation of the particular branches and agencies. 190/

In September 1986, the Commission issued an interpretive release setting forth its position on the application of the Section 3(a)(2) exemption to securities issued or guaranteed by domestic branches and agencies of foreign banks. 191/ In that release, the Commission announced that it deemed a branch or agency of a foreign bank located in the United States to be a

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(footnote continued)

188/ fact that in 1933 there was little public disclosure of bank financial information, and that the existing bank supervision had not prevented widespread failures in the banking system. Butera, Bank Exemption from the 1933 Securities Act, 93 Banking L.J. 432, 457 (1976). In fact, early drafts of the Securities Act provided that banks would file registration-type materials with bank regulatory authorities, but this was later deleted without explanation. See id. at 443-47 (and authorities cited therein).

189/ See supra pp. 26-30 (discussion of International Banking Act).

190/ See, e.g., Algemene Bank, Nederland, N.V. (Division of Corporation Finance no-action letter avail. Aug. 30, 1971); Mitsui Bank, Ltd. (Division of Corporation Finance no-action letter avail. Nov. 30, 1981).

191/ Securities Act Release No. 6661 (Sept. 23, 1986).

"national bank," or a "banking institution organized under the laws of any state, territory, or the District of Columbia," within the meaning of Section 3(a)(2), provided that the nature and extent of federal and/or state regulation and supervision of the particular branch or agency is substantially equivalent to that applicable to federal or state chartered domestic banks doing business in the same jurisdiction. Thus, a security backed by a standby letter of credit or otherwise "guaranteed" by a domestic branch or agency of a foreign bank subject to regulation and supervision substantially equivalent to that applicable to a domestic bank is exempt from registration under the Securities Act.

B. Financial Guarantee Insurance

Insurance companies providing financial guarantees backing debt securities have not registered the guarantees in reliance on Section 3(a)(8) of the Securities Act. That Section provides an exemption from registration for certain insurance policies and annuity contracts regulated by state insurance commissioners. Although Section 3(a)(8) is phrased as an exemption, the Commission has taken the position that it provides an exclusion from all provisions of the Securities Act. 192/

192/ Securities Act Release No. 6558 (Nov. 21, 1984). Furthermore, an instrument that is described in Section 3(a)(8) of the Securities Act has been held not to be a security subject to the antifraud provisions of the Securities Exchange Act of 1934. See Otto v. Variable Annuity Life Ins. Co., [1986-87] Fed. Sec. L. Rep. (CCH) ¶ 93,012 (7th Cir. Dec. 8, 1986),

(footnote continued)

An insurance company's policy guaranteeing payment of principal and interest on a tax-exempt municipal bond has been deemed to be exempt under Section 3(a)(8) of the Securities Act. 193/ Similarly, an insurance company's financial guarantee bond insuring the timely payment of amounts due under debentures to be offered publicly by a noninsurance subsidiary of an insurance company has been treated as exempt under Section 3(a)(8). 194/

192/ (footnote continued)

rev'd on rehearing on other grounds, 817 F.2d 30 (7th Cir. April 15, 1987) (holding that contract was not within Section 3(a)(8)); see also H.R. Rep. No. 85, 73rd Cong., 1st Sess. 15 (1933) ("Paragraph 8 makes clear what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes. The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible.") In contrast, bank issued or guaranteed securities, while exempted from registration under the Securities Act and from the liability provisions of Section 12(2) of that Act, have not been considered to be excluded from the anti-fraud provisions of Section 17 of the Securities Act nor exempted from the provisions of the Securities Exchange Act of 1934.

193/ American Municipal Bond Assurance Corp. (Division of Corporation Finance no-action letter avail. July 17, 1972).

194/ Sentry Financial Services Co. (Division of Corporation Finance no-action letter avail. Feb. 7, 1977). Not every instrument labeled as an insurance policy or an annuity contract, however, falls within the exclusion of Section 3(a)(8). For example, a variable annuity contract in which the entire investment risk remains with the annuity holder is not an annuity contract for purposes of Section 3(a)(8).

(footnote continued)

Thus, under the Securities Act, any security guaranteed by a bank, and the guarantee itself, are exempt from the registration requirements and from the private liability provisions of Section 12(2). However, both the guaranteed security and the guarantee are subject to the antifraud provisions of Section 17. 195/ Insurance policies that guarantee securities are excluded from the Act in its entirety if those policies come within Section 3(a)(8). Securities guaranteed by insurance

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194/ (footnote continued)

SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959). Similarly, variable annuity contracts in which the investment risks borne by the respective insurance companies are not deemed significant are not considered to be annuity contracts for purposes of Section 3(a)(8). SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); Peoria Common Stock Yards Co. v. Penn. Mutual Life Ins. Co., 698 F.2d 320 (7th Cir. 1983).

The Commission has adopted Rule 151 under the Securities Act, which establishes a "safe harbor" within Section 3(a)(8) for certain types of annuity contracts. Securities Act Rel. No. 6645 (May 29, 1986). To come within the Rule, the contract must (1) be issued by a corporation subject to the supervision of the state insurance commissioner, bank commissioner, or any agency or officer performing like functions, (2) include guarantees of principal and interest sufficient in degree for the issuer to be deemed to have assumed the investment risk, and (3) not be marketed primarily as an investment. While compliance with Rule 151 will assure "non-security status," failure to comply does not necessarily result in the annuity contract being denominated a security outside the Section 3(a)(8) exclusion. Cf. Otto v. Variable Annuity Life Ins. Co., 817 F.2d 30 (7th Cir. 1987) (relying heavily on Rule 151 in holding that the contract in question was a security). The Commission, however, has taken the position that the rationale underlying the conditions set forth in the rule is relevant to any Section 3(a)(8) determination. Securities Act Rel. No. 6645.

195/ Section 17(c) of the Securities Act.

policies, however, generally are subject to all of the Securities Act's requirements, including the registration requirements of Section 5, unless a separate exemption applies. For example, in the case of tax-exempt municipal bonds, which generally are exempt under Section 3(a)(2), the registration requirements would not apply.

V. COMPETITION BETWEEN BANKS AND INSURANCE COMPANIES

Generally, banks and insurance companies compete directly for financial guarantee business. Both insurance policies and bank letters of credit, properly written, provide investors with irrevocable, unconditional guarantees of an issuer's obligations. Both kinds of guarantees allow investors to look to a generally more creditworthy party for payment of principal and interest. Accordingly, from the perspective of both the purchaser of the guarantee and the investor, guarantees provided by domestic banks, foreign banks, and insurance companies are functionally equivalent.

In the municipal bond market, where these guarantors compete on essentially equivalent terms under the Securities Act which exempts municipal bonds from registration, insurance companies and foreign banks (through their domestic branches and agencies) dominate. In the corporate debt market, however, banks have an advantage under the Securities Act, since a security backed by a bank standby letter of credit is exempt from the Act's registration requirements. The Commission is unable to quantify the effect of the registration exemption on competition at this time, because no empirical information concerning relative market shares is available.

A. Municipal Bond Market

In the municipal bond market, banks and insurance companies compete primarily based on price and savings to the purchasers of guarantees, typically debt issuers. The price of a financial guarantee of a publicly-held security is the fee charged by the

issuer of a standby letter of credit or the premium charged by an insurance company. The amount of the fee or premium is generally fixed at the time of the issuance of the guarantee; it may be paid in full upon issuance or in periodic installments. 196/

In recent years, price competition among financial guarantors has increased. Successful bids to provide financial guarantees have been as low as six or nine basis points (one-hundredths of one percent), although they range as high as 100 or 200 basis points. 197/

The savings resulting from the financial guarantee are primarily savings to the issuer in interest paid on the underlying debt, generated by increasing the perceived safety or creditworthiness of the issue through "borrowing" the guarantor's credit rating. 198/ The savings, or difference in yield, represents an annual cost savings to the issuer of the underlying security.

As described above, insurance policies and bank letters of credit generally provide irrevocable, unconditional guarantees

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196/ Financial Security Assurance letter at 20.

197/ *See* American Bankers Association letter at 8; Financial Security Assurance letter at 21; Weiner, *supra* note 56, at 12; Rudnitsky, *supra* note 151, at 41.

198/ Financial Assurance Security letter at 21; Van Kampen Merritt letter at 2. In addition, according to some commenters, some securities, particularly structured financings, are considered too complex to be marketed publicly unless analysis of the transaction is simplified by the use of a credit enhancement. By enabling the securities offering to be marketed to the public, the yield of the security may be lowered, enabling the issuer to avoid paying a higher interest rate. Financial Security Assurance letter at 21.

of payment of principal and interest. 199/ Thus, the savings generated by the guarantee depends not on the type of guarantor or guarantee, but on the perceived creditworthiness of the guarantor as demonstrated by its rating. Accordingly, that rating is a major competitive factor. As a practical matter, guarantors without the highest credit rating are not able to offer issuers the interest savings that a AAA guarantor can.

Municipal bonds generally are exempt from registration pursuant to Section 3(a)(2). Because both insurance policies and bank letters of credit are also exempt from registration, insurance companies, domestic banks, and foreign banks compete on equivalent terms under the Securities Act in providing guarantees of those bonds. Information is available on relative market shares for guarantors of municipal bonds. The insurance companies' share of this market grew from 47% to 65% between 1984 and 1986. In the same period, foreign banks' share grew from 20% to 24%, while domestic banks' share dropped from 33% to 11%. 200/

It appears that the major reason for the decrease in the share of the market held by domestic banks is the reduction in

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199/ See supra p. 18 (bank letters of credit) and pp. 37-38 (insurance policies).

200/ Financial Security Assurance letter at 19, based on information from Securities Data Company, Inc. The American Bankers Association provided similar data for 1985 and 1986. See attachment to American Bankers Association letter.

their credit ratings. 201/ At present, most U.S. money center banks are not rated in the highest category, while a number of insurance companies and foreign banks are rated AAA. 202/ Although banks with lower ratings may still issue standby letters of credit, they are unable to offer issuers the same savings and thus have suffered competitively. 203/

There are other factors that may account in part for the decline in domestic banks' market share. Bankers may be charging

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201/ One insurer also indicated that, in the municipal debt market, banks dominate in providing guarantees for short-term debt, while insurance companies dominate the market for long-term debt. See Financial Security Assurance letter at 19; Commission hearing at 40-41 (statement of Lopp). This, according to the insurers, results from banks' inability to provide standby letters of credit for terms longer than ten years. Commission hearing at 41 (statement of Lopp). It does not appear that this inability results from any direct regulatory restriction. For example, the Comptroller of the Currency's regulations simply provide that a letter of credit be for a definite term. 12 C.F.R. 7.7016(b). Rather, the inability appears to be a matter of industry practice grounded in prudence and restraint in lending.

202/ Neubecker, supra note 166, at 117; Financial Security Assurance letter at 22.

203/ See Weiner, supra note 56, at 12; Standard & Poor's, Credit Overview: Corporate and International Ratings 61 (1983). In recognition of this competitive disadvantage, at least one bank has established a municipal bond insurance subsidiary to compete in the municipal bond market. See American Bankers Association letter at 3, citing letter of Michael Patriarca, Deputy Comptroller for Multinational Banking, to Patrick J. Mulhern, Senior Vice President and General Counsel, Citibank, N.A. (May 2, 1985) (decision of the Office of the Comptroller of the Currency concurring in proposal to establish insurance subsidiary). The Comptroller's decision was upheld by the United States District Court for the District of Columbia. American Ins. Ass'n v. Clarke, 656 F. Supp. 404 (D.D.C. 1987).

higher prices for letters of credit, due to increased regulatory monitoring of this activity, in anticipation of the likely adoption of risk-based capital guidelines, or out of concern that lower prices do not adequately compensate for risk. 204/

In addition, it has been suggested that foreign banks have a major competitive advantage over domestic banks because of their lower cost of capital. 205/ Japan's trade surplus and high savings rate, it is argued, result in a low cost of capital for Japanese banks, allowing them to underprice domestic guarantors. 206/ Others

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204/ See supra p. 32.

205/ See letter from Michael Djordjevich, President and Chief Executive Officer, Capital Guaranty Corporation, to Jonathan G. Katz, Secretary, SEC, dated March 12, 1987, at 2 ("Capital Guaranty letter").

206/ See Hawley and Sinclair, Low-Cost Capital Gives Japanese an Advantage, Am. Banker, Jan. 22, 1987, at 4, 15; Ely, Dawn of a New Age, Institutional Investor, March 1987, at 246; Kearns, Japan Off to Running Start for a Wall Street Foothold, Chi. Trib., Apr. 8, 1987, at 1-2; see also Department of the Treasury, National Treatment Study (1986 Update) at 74 ("funding costs of Japanese banks tend to be lower than those of foreign banks since they have a large network of deposits at controlled interest rates on which to draw").

It has been suggested that the Japanese banks have an advantage since they are subject to lower capital requirements than United States banks. See Financial Security Assurance letter at 21 and B-3; Capital Guaranty letter at 2; see also Cong. Rec. S5614 (daily ed. April 28, 1987) (statement of Sen. Proxmire)(expressing hope that Japanese banking officials will participate in capital adequacy discussions among supervisory officials of the member nations of the Bank for International Settlements); Nash, Volcker Sees Nations in Bank Pact, N.Y. Times, July 31, 1987 at D1 (referring to negotiations among "central bankers and regulators from [the U.S.,] Japan, Britain and other members of the European Community on an accord that would set a common standard for measuring a bank's capital levels").

have argued that Japanese banks are willing to price guarantees substantially below market, seeking to increase market share and develop long-term banking relationships. 207/

B. Corporate Debt Market

In contrast to the municipal bond market, in the corporate debt market, financial guarantees issued by banks provide one type of cost savings to issuers of the underlying securities not available from insurance companies: an exemption from registration under the Securities Act. This exemption saves the issuer the registration fee (two basis points of the offering price of the security) 208/ and the costs arising from any delays associated with the registration process. 209/ It also avoids potential liability under the civil liability provisions contained in Sections 11 and 12 of the Securities Act. 210/

Because of the relatively low fees charged for guarantees, it would seem that the Securities Act exemption provides a competitive advantage to banks. There is, however, only anecdotal evidence to

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207/ *See* Kearns, *supra* note 206, at 2.

208/ *See* Section 6(b) of the Securities Act.

209/ *See* Financial Security Assurance letter at 23.

210/ Liability under Section 11 of the Act arises only in connection with registration statements. And, as discussed *supra* note 192, securities guaranteed by banks also are exempted from Section 12(2) liability.

this effect. 211/ There are no published studies analyzing the corporate debt market and commentators provided no data on competition between banks and insurance companies in this market. Thus, the Commission cannot quantify the impact of the exemption.

One insurer estimated that "the dollar volume of debt issues in 1986 involving a letter of credit is approximately ten times the volume of issues supported by a financial guarantee insurance policy". 212/ This estimate is not directly relevant to the impact

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211/ See Commission hearing at 7 (statement of Lopp).

In addition to the Section 3(a)(2) exemption from registration, at least four other factors may favor banks in this market. First, the market for guarantees of corporate debt, particularly structured financings, is relatively new, and insurers apparently entered the field after banks. Financial Security Assurance, the first monoline corporate insurer, began operating in 1985. This late entry may give banks a larger market share today.

Second, foreign banks, particularly Japanese banks, are apparently willing to underprice insurance financial guarantees by issuing standby letters of credit for lower fees, sacrificing short-term profits for long-term banking relationships. See Weiner, supra note 58, at 12; Capital Guaranty letter at 1 ("we can cite two specific transactions where a Japanese bank letter of credit was bid substantially lower and subsequently purchased in lieu of our financial guaranty").

Third, in many structured financings, banks sell the assets, such as credit card receivables, to the issuer, and control the structuring of the transaction. Banks may be more likely to use letters of credit than insurance to support the transactions they originate, in part because of their familiarity with those instruments.

Fourth, banks often have a pre-existing banking relationship with a corporate issuer. This relationship may enable a bank to assess the issuer's creditworthiness more readily.

212/ Financial Security Assurance letter at 20.

of Section 3(a)(2) on competition, since it includes transactions in which letters of credit guaranteed less than all of the principal and interest owed. In many structured financings, letters of credit and insurance policies guarantee only a portion of the principal and interest. Such a transaction may nevertheless qualify for a AAA rating because of over-collateralization and perceived quality of the underlying assets. Guarantees also may be used to ensure adequate cash flow. 213/ In such cases, where the guarantee does not ensure payment of all of the principal and interest, the Section 3(a)(2) exemption is not available, and thus has no effect on competition. In fact, the estimate may indicate that bank letters of credit are used more often than insurance policies to guarantee only part of a transaction. If this is true, banks may dominate this market without the Securities Act exemption.

Moreover, to the extent that any competitive impact on insurance guarantees results from timing uncertainties caused by registration, delay is minimized for those offerings made via "shelf" registration. Rule 415 under the Securities Act allows issuers to register certain offerings of securities to be sold on a delayed or continuous basis. Securities may be registered in advance of an offering, allowing the issuer to time the offering to coincide with advantageous market conditions. Rule 415 has other benefits as well. Its flexibility permits an issuer to

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213/ See, e.g., Standard & Poor's Credit Week, Mar. 16, 1987, at 20-21.

vary the structure and terms of securities on short notice, enabling registrants to match securities with the current demands of the marketplace. In addition, only a single registration statement need be filed for a series of offerings by an issuer, rather than a separate registration statement each time an offering is made.

Debt securities guaranteed by insurance policies may be registered pursuant to Rule 415, if the conditions of the Rule are met. For example, Rule 415 may be used for delayed or continuous offerings of mortgage-related securities and for delayed offerings by issuers eligible to use Form S-3 or Form F-3. 214/ In addition, majority-owned subsidiaries of companies that are eligible to use Form S-3 may use that form to sell off the shelf investment grade nonconvertible debt and preferred securities or any securities that are guranteed by the parent corporation.

Thus, in a structured financing, an S-3 company may form a subsidiary to hold the income-producing assets and issue and sell off the shelf investment grade debt or preferred securities or issue such securities itself. By using Rule 415, the issuer

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214/ See Rule 415(a)(1)(vii) and (x). Companies eligible for Form S-3 must have been subject to the Exchange Act periodic reporting requirements for at least 36 months prior to the filing of the registration statement; filed all Exchange Act reports in a timely manner during the 12 month period immediately preceding the filing of the registration statement; and made all dividend and sinking fund installment payments on preferred stock, and paid all installments

(footnote continued)

is able to reduce uncertainties caused by volatile markets and delays in the registration process.

Because the impact of the exemption cannot be quantified, it is difficult to argue that the competitive impact alone establishes the need for providing equivalent Securities Act treatment of the financial guarantee activities of banks and insurance companies. Functionally, however, the guarantees provided by banks and insurance companies are equivalent, raising the question of whether other factors support differential Securities Act treatment.

214/ (footnote continued)

on debt and rental obligations on long-term leases, since the end of the last fiscal year for which financial statements were included in an Exchange Act report (except to the extent any defaults in such payments, in the aggregate, were not material to the financial position of the company and its subsidiaries as a whole). A registrant eligible to use Form S-3, may use the Form S-3 for a primary offering of investment grade non-convertible debt or preferred securities. Alternatively, for a primary offering to be registered on Form S-3, at least $150 million of the registrant's voting stock must be held by nonaffiliates; or at least $100 million of its voting stock must be so held, and the trading volume of such stock must exceed 3 million shares annually. (Form F-3, which has similar requirements, may be used only by foreign issuers.)

VI. PROPOSED RESPONSES TO ANY DISPARATE TREATMENT

The Commission has considered three approaches that would place the financial guarantee activities of banks and insurance companies on equal footing under the Securities Act. First, it has examined the proposal put forward by certain insurers to amend the Securities Act to exempt from its registration provisions securities that are guaranteed by insurance policies and rated in the highest rating category by at least two rating agencies. Second, it has considered the elimination, by legislation or reinterpretation of Section 3(a)(2), of the exemption from registration for securities backed by bank guarantees. Third, it has examined the need for general exemptive authority under the Securities Act, which would allow the Commission to exempt appropriate debt securities guaranteed by insurance policies, as well as other classes of or transactions in securities.

The Commission believes that arguments presented in favor of an insurance exemption deserve consideration. 215/ These arguments are not, however, unique to insured securities and transactions, and other classes of securities and transactions may present arguments for exemptions that are at least as cogent as those presented by proponents of an insurance exemption.

215/ As noted above, Commissioner Peters expressly disassociates herself from any implication that might be drawn from this Report on whether or how the recommended general exemptive authority under the Securities Act might be used to grant relief to the insurance industry. The Commissioner believes it inappropriate and unnecessary to review this issue now.

Moreover, the legislative proposals for an insurance exemption proposed to date are problematic in several respects. Most fundamentally, the Commission is concerned that the presence of a guarantor may not be an adequate substitute for disclosure of material information regarding a public offering. The Commission also recognizes that adoption of a statutory exemption for insured securities runs counter to the recommendations of the Bush Task Group. In addition, the legislative proposals suffer from various shortcomings that could be better addressed through rulemaking or exemptive orders.

The Commission believes that any apparent competitive disparity can be resolved through two approaches, both of which are consistent with investor protection and the public interest, as well as the recommendations of the Bush Task Group. First, the Commission recommends that Congress amend Section 3(a)(2) of the Securities Act to eliminate the exemption from registration for securities issued or guaranteed by banks. That recommendation would place the financial guarantee activities of banks and insurance companies on an equal footing under the Securities Act, and, at the same time, ensure that investors in securities backed by financial guarantees receive full and fair disclosure under the Act's registration provisions. 216/

216/ The Commission believes that reinterpreting Section 3(a)(2) to require registration of securities backed by standby letters of credit is not appropriate. The Commission continues to believe that a standby letter of credit is tantamount to a guarantee, and that a security backed by a standby letter of credit is a security "guaranteed" by a bank. In any event, such a reinterpretation would not resolve the competitive disparity between banks and insurance companies in the financial guarantee market because certain state banks have power to issue other kinds of guarantees.

Second, the Commission recommends that Congress amend the Securities Act to provide authority for the Commission to grant exemptive relief from the registration provisions of the Securities Act for those securities or securities transactions for which full registration is unnecessary. Such authority would allow the Commission to fashion relief, when appropriate and under circumstances consistent with the purposes of the Act, for securities and securities transactions that warrant exemption. 217/ Such authority also would provide for flexibility that would allow the Commission to adapt exemptive provisions in response to evolving market circumstances.

A. The Proposed Exemption for Debt Securities Guaranteed By Insurance Policies

Insurers have proposed an exemption from the registration provision of the Securities Act for securities supported by financial guarantee insurance. The exemption would be limited to debt securities 218/ that are guaranteed by an insurance

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217/ General exemptive authority can be provided with or without repeal of Section 3(a)(2). If Section 3(a)(2) is repealed, general exemptive authority could be used to craft exemptions for bank guaranteed securities as well as securities guaranteed by insurance companies. If Section 3(a)(2) is not repealed, exemptive authority could, if appropriate, be used to reduce the competitive disparity in the financial guarantee market, to the extent consistent with investor protection, the public interest, and the purposes of the Act.

218/ *E.g.*, notes, bonds, debentures, evidences of indebtedness, or collateral trust certificates, and any guarantees of the foregoing. *See* Financial Security Assurance letter at 4-5. Financial Security Assurance also suggested including certificates of participation in a trust whose assets consist of the foregoing instruments. *Id.* at 5.

policy, and rated in the highest rating category by at least two nationally recognized statistical rating organizations. 219/ In addition, the insurer would be required to be a reporting company under the Securities Exchange Act of 1934. 220/

Proponents assert that there are four levels of investor protection under the proposed exemption: (1) the insurer's review of the issuer and the guarantee itself; (2) state regulation of financial guarantee insurers; (3) the credit rating of the debt issue; and (4) Exchange Act disclosure by the insurer. 221/ They argue that these protections will help ensure the safety and security of securities backed by financial guarantee insurance, and that any remaining disclosure concerns can be addressed through the liability imposed for misstatements under Section 12(2) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. 222/

1. Insurer's Review of the Issuer and the Guarantee Itself

In the Commission's view, the presence of a guarantor is not

219/ *Id.* at 5.

220/ *Id.*

221/ *Id.* at 9.

222/ *Id.* at 9-15; letter from W. James Lopp, Chairman and President, Financial Security Assurance Inc., to Jonathan G. Katz, Secretary, SEC, dated April 23, 1987 at 1 ("Financial Security Assurance supplemental letter"). The proposed exemption would be placed in a new Section 3(a)(12) of the Securities Act. *Id.* Unlike Section 3(a)(8), which provides an exclusion from the provisions of the Securities Act (*see supra* p. 64), Section 3(a)(12) would provide only an exemption from the registration provisions.

determinative of whether a security should be exempt from the registration provisions of the Securities Act. The Securities Act is designed to provide full and fair disclosure of the character of securities sold to the investing public. While the presence of a guarantor is a material factor that investors may wish to consider in determining whether to invest in a particular debt issue, the Commission does not believe that it can, in general, serve as a substitute for disclosure of other material information regarding the offering.

Investors in public offerings of securities backed by insurance policies have an interest in information allowing them to assess the financial resources of both the issuer and the insurer. Investors also have an interest in assessing other material matters in addition to the solvency of the issuer and its guarantor. For example, the terms of the security being guaranteed or the terms of the guarantee are of importance to investors. If the issuer has the right to call a bond prior to maturity, or if the guarantor has the power to accelerate payment of principal upon default, investors may find their return dramatically altered.

In structured financings, which often use financial guarantees, prepayments on the underlying assets can greatly affect an investor's return. 223/ Generally, a guarantor does not guarantee

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223/ See Spratlin and Vianna, An Investor's Guide to CMOs, Salomon Brothers Inc., May, 1986, at 10-16; see also "Stripped" Mortgage-Backed Ratings Initiated, Standard & Poor's, Credit Week, Feb. 9, 1987, at 15.

against prepayment, nor do rating agencies assess this risk. 224/ Nonetheless, these matters are material to an investment decision and are currently addressed under the Securities Act's registration requirements in public offerings. Thus, the Commission observes that the presence of an insurance policy may not, in general, serve as an adequate substitute for disclosure of material terms of the proposed transaction.

2. State Regulation

The Commission has concerns about the adequacy of state regulation governing financial guarantee insurers. These concerns are not unique, and have been stated by state insurance commissioners. Indeed, the concerns about the lack of adequate regulation governing financial guarantee insurers led to the formation of the NAIC Financial Guarantee Study Group. The Group was established to make recommendations to the various states on the most appropriate regulatory response to the rapid growth of the financial guarantee market. Although the NAIC has proposed model legislation to regulate financial guarantee insurers, that

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224/ See Western Auto Financial Loans, Registration Statement on Form S-1 (filed Sept. 24, 1986), at 7; letter from Kurt D. Steele, Senior Vice President and General Counsel, Standard & Poor's Corporation, to Jonathan G. Katz, Secretary, SEC, dated March 13, 1987, at 1 ("Standard & Poor's Corporation letter"); Standard & Poor's, Credit Week, Mar. 16, 1987, at 4.

legislation has not been adopted by any state. 225/

The current level of state regulation does not provide for safe and sound operation of financial guarantee insurers. Even if adequate uniform legislation were enacted by the states, however, it would not substitute for full and fair disclosure under the Securities Act. The goal of state regulation is to assure the safe and sound operation of financial guarantee insurers. 226/ While investors may consider the state's regulatory scheme material to their investment decision, the existence of a state regulatory

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225/ It is uncertain whether or how quickly legislation will be enacted. Some have suggested that if New York passes legislation, others will follow. Morrissey & Marino, *supra* note 94, at 13. However, this may not happen quickly, if the experience with municipal bond insurance regulation is a guide. Although such insurance was first sold in the early 1970's, the first legislation tailored to it was not enacted until 1980, by New York. Seven years later only three other states have adopted similar regulations.

226/ The Model Bill does not absolutely ensure the solvency of insurers. In that regard, the Model Bill Memo states that

> [t]he purchasers of [financial guarantee insurance] are, or should be, financially astute bankers, investment bankers, and limited partnership syndicators. There is a danger that "risk free investment" will remove discipline from the investment community. Having insurers assume the investor's risk is not the most prudent or socially beneficial use of today's limited multiline insurance capacity. Removing these lines from Guaranty Fund protection will add discipline to the market. In order to discharge their prudent person responsibilities, purchasers of these products, rather than using price as the primary criterion, will have to evaluate more closely the financial condition and ability of the insurer to meet its obligations, as the Guaranty Fund will no longer be available.

Model Bill Memo at 21.

scheme is not a substitute for disclosure under the Securities Act, particularly with respect to significant factors that are specific to individual transactions, e.g., call provisions and other terms that may significantly affect yield.

3. Credit Ratings

The ratings issued by rating agencies are not adequate substitutes for the Securities Act's registration requirements or the Exchange Act's periodic reporting requirements. In issuing ratings, the agencies attempt only to assess the likelihood of payment of principal and interest on debt obligations. 227/ Their ratings are neither evaluations of other information material to investors, nor recommendations to purchase securities. 228/

227/ In the case of insured issues, where the perceived likelihood of payment of principal and interest is based on the creditworthiness of the insurer, any change in the credit rating of the insurer has an immediate adverse impact on the insured issues. The Risky Business of Insuring Muni Debt, Bus. Wk., April 27, 1987 at 97. A downgrade of the insurer can thus affect the market value of these bonds. For example, Standard & Poor's downgrading of Industrial Indemnity Co. from AAA to AA affected over 260 tax exempt bond issues. Morrissey & Marino, supra note 94, at 11. Similarly, issues backed by bank standby letters of credit are typically downgraded when the credit rating of the bank providing the credit is downgraded. See, e.g., Weberman, Three Notches Down, Forbes, July 27, 1987, at 171 (describing downgrade of housing bonds backed by Bank of America letters of credit from AAA to BBB).

228/ See Standard & Poor's Corporation letter at 1. Nor is the issuance of ratings regulated. While each of the five "nationally recognized statistical rating organizations" is registered with the Commission as an investment adviser, the Commission does not exercise general oversight over the functions and processes of the rating agencies, and they are not supervised by any other regulatory body.

As the most widely followed rating agency emphasizes, ratings are based on information supplied by the issuer (and, in this case, the insurer); the agencies do not perform an audit of such information. 229/ Moreover, they have no special or fiduciary relationship with the issuer, insurer, or anyone else in the process that would replace Securities Act liability. 230/

Indeed, in rating securities, the agencies rely in part on the Securities Act registration materials and information furnished by the issuers, underwriters, and professionals. Standard & Poor's expressed the concern that eliminating the registration requirement and liability under Section 11 might reduce the standard of diligence exercised by these persons, and thus reduce the value of the disclosures made to the rating agencies. 231/

229/ *See* Standard & Poor's Corporation letter at 2; *see also* Fitch Investors Service, Inc., *supra* note 150, at iv. Standard & Poor's and Moody's Investor Service opposed conditioning an exemption based on ratings, for many of the reasons given herein. Standard & Poor's Corporation letter at 1; letter from Thomas J. McGuire, Executive Vice President, Moody's Investor Service, to Jonathan G. Katz, Secretary, SEC, dated March 13, 1987 at 8. Fitch Investors Service, Inc., on the other hand, supported the proposed exemption, and suggested broadening it to include insured securities rated in the top three categories. *See* letter from Jack A. Vogel, Vice President, Fitch Investors Service, Inc., to Jonathan G. Katz, Secretary, SEC, dated March 4, 1987, at 2.

230/ In this regard, Securities Act Rule 436 exempts rating organizations from Section 11 liability for ratings included in a registration statement.

231/ *See* Standard & Poor's Corporation letter at 2. Notably, in the Commission's final report in its investigation concerning securities of the City of New York, the Commission found that the agencies were hampered by the lack of disclosure

(footnote continued)

Moreover, rating agencies frequently disagree among themselves as to the appropriate rating even for securities that obtain the highest possible rating from at least one agency. One study concluded that the two most widely followed agencies disagreed 58% of the time. 232/ In addition, even among securities that have equivalent ratings from two or more rating agencies, there can be significant differences in market rates of return. 233/ The presence of such disparities in ratings, and in yields within classes of securities with equivalent ratings, suggests that an

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231/ (footnote continued)

requirements for municipal issues. See Securities and Exchange Commission, Final Report in the Matter of Transactions in the Securities of the City of New York, submitted to Senate Comm. on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess. 27 (Comm. Print 1979).

While the antifraud provisions of Securities Act Section 12(2) and Exchange Act Section 10(b) and Rule 10b-5 do address misleading disclosures, they are not substitutes for Section 11. Unlike Section 11, liability under Section 10(b) requires a showing of scienter. A showing of reliance is also generally required under Section 10(b) in private actions. Although Section 12(2) imposes a standard of care similar to that imposed by Section 11, it retains the concept of privity, imposing liability on a narrower range of persons. Under the proposed exemption, the insurer would be deemed to be a seller for purposes of Section 12(2), but only as to misstatements or omissions relating to the insurance policy or the insurer. Financial Security Assurance supplemental letter at 1, 3.

232/ Perry, supra note 159, at 313.

233/ Spreads may be as much as 75 basis points within categories, Willoughby, Uncertain Umpires, Forbes, June 16, 1986, at 131, 134, and AAA rated insured issues often have rates of return comparable to uninsured issues rated AA. Fabozzi & Pollack, supra note 147, at 398. See also Faces Behind the Figures, Forbes, Aug. 10, 1987 at 113 (some insured bonds yield approximately 20 basis points more than comparable uninsured bonds rated AAA.)

agency rating does not convey all information that the market may find material.

While ratings are used as a basis to reduce other regulatory requirements under the securities laws, elimination of Securities Act registration based on such ratings would greatly expand the rating agencies' role. It would be the only instance under the Securities Act where ratings would provide a basis for an exemption from registration. The other uses of ratings under the securities laws serve substantially different purposes from the current proposal.

For example, in its integrated disclosure system, the Commission has conditioned, in some instances, use of Form S-3, which maximizes use of incorporation by reference, on, among other things, an investment grade rating. Form S-3 nonetheless maintains the objectives of disclosure under the Securities Act -- making available to the public meaningful information on which to make investment decisions and providing for Securities Act liability to enhance the accuracy of that information. The high rating is viewed as an indication of the degree of information disseminated and analyzed in the marketplace. By allowing incorporation by reference of other reported information, Form S-3 serves as a partial substitute for physical delivery of disclosure information to investors, but not as a basis for an exemption from registration. 234/

234/ *See* Securities Act Rel. No. 6331 (Aug. 6, 1981).

Ratings also have been used to prescribe permissible hedging techniques and to allow reduced haircuts under the Commission's net capital rule for broker-dealers, 235/ and as a basis for an exemption from an anti-manipulation rule under the Securities Exchange Act. 236/ In addition, they have been proposed as a condition for an exemption for foreign banks from the provisions of the Investment Company Act of 1940 (but not from the Securities Act). 237/ None of these uses is comparable to an exemption from the disclosure requirements of the Securities Act. 238/

Additionally, Congress has previously rejected a transactional exemption from Securities Act registration for certain mortgage-backed securities based in part on credit ratings of the securities.

235/ Securities Exchange Act Rule 15c3-1(c)(2)(vi)(F) (providing that positions in investment grade bonds may be hedged with Treasury bond positions and that haircuts for commercial paper and convertible debt securities are reduced for certain grades of those instruments).

236/ Securities Exchange Act Rule 10b-6(a)(3)(xii).

237/ Investment Company Act Rel. No. 15314 (Sept. 17, 1986) (proposing Rule 6c-9).

238/ Ratings are also used to determine whether certain securities are eligible for shelf registration under Securities Act Rule 415; to determine the availability of an exemption from Securities Exchange Act margin restrictions for mortgage-backed securities, *see* Sections 7(g) and 8(a) of the Securities Exchange Act; *and* to determine whether to allow investment companies to purchase securities in an underwriting where a principal underwriter is affiliated with an investment company. *See* Investment Company Act Rule 10f-3. The Commission also has proposed using ratings as a condition for an exemption allowing futures trading on certain foreign government debt. *See* Securities Exchange Act Rel. No. 34-24428 (May 5, 1987) (proposed amendments to Rule 3a12-8).

That approach was rejected because of concerns about the accuracy of ratings and about the delegation to private, unregulated entities of the power to exempt offerings. 239/

Finally, the proposal for a new exemption would create two different competitive disparities. One disparity would be between investment grade issuers and non-investment grade issuers, which might inhibit the capital raising efforts of smaller, less seasoned entities, by increasing the differential between their cost of capital and the cost of larger entities. 240/ Another disparity would be between issuers that purchase insurance to be rated AAA and those that are rated AAA without a credit enhancement. The latter would not be exempt, although the rating agencies view them as equally creditworthy.

3. Securities Exchange Act Reporting by the Insurer

While the availability of reports by the insurer may be of value to the investor, those reports are not generally an effective

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239/ See H.R. Rep. No. 994, 98th Cong., 2nd Sess. 9 (1983). While the Commission supported the proposed exemptions, it did so based in large part on the belief that the exemption would be limited to sales to institutional and similar purchasers. See Secondary Mortgage Market Enhancement Act: Hearing on H.R. 4557 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 98th Cong., 2d Sess. 54 (1984) (statement of Commissioner Cox).

240/ See letter from David K. Aylward, Executive Director, Alliance for Capital Access, to Jonathan G. Katz, Secretary, SEC, dated April 8, 1987. Financial guarantee insurers indicate that they do not insure debt that they do not believe is investment grade. See Financial Security Assurance letter at 10. Thus, it would be difficult, if not impossible, for below-investment grade issuers to avail themselves of the proposed exemption.

substitute for Securities Act registration because they do not contain material information about the issuer, 241/ or about other material aspects of the offering. 242/ Further, the liability provisions of the Securities Act do not attach to those reports. Although the Commission has previously allowed those reports to be incorporated by reference into Securities Act registration statements in the integrated disclosure system, it has never allowed such reports to be a basis for an exemption from registration, let alone an exemption for a different issuer. 243/

The proponents of the exemption argue that not all of the Exchange Act reporting requirements for the issuer of a guaranteed

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241/ See Section 12(h) of the Securities Exchange Act. As described supra p. 8 and note 9, the periodic reporting provisions apply only to issuers of securities registered under the Securities Act, securities listed on national securities exchanges, and certain equity securities. Periodic reporting is also required by the NASD as a condition to having a class of securities quoted on NASDAQ. NASD By-Laws, Schedule D, Part II, reprinted in NASD Manual (CCH) ¶ 1653A. Thus, the proposed exemption for insured debt securities would have the effect of exempting issuers of such securities from periodic reporting provisions, unless the issuer chose to list a class of securities on an exchange or have its securities quoted on NASDAQ.

242/ Recent experience with mortgage insurance underscores the desirability of periodic reporting information about the underlying issuers. In the case of Ticor Mortgage Insurance Co., offerings which it insured received investment grade ratings. When Ticor could not meet its commitments arising from the default of one loan originator, Standard & Poor's downgraded all other Ticor insured bonds to CCC without regard to their underlying creditworthiness, destroying their marketability. Willoughby, supra note 233, at 134.

243/ See supra p. 88 (discussing use of ratings in integrated disclosure system).

security are cost-effective, if periodic reporting by the insurer is required. 244/ However, the Commission believes that it is not appropriate to give, in effect, a blanket exemption from Exchange Act reporting for the issuer. Instead, Exchange Act reporting by the issuer may be tailored pursuant to the Commission's broad exemptive powers under Section 12(h) of the Exchange Act to preserve adequate public information, while minimizing unnecessary disclosure. The Commission has employed a similar approach to adjust the Exchange Act's reporting requirements for certain mortgage-backed securities, thereby eliminating unnecessary burdens, while preserving adequate periodic disclosure. 245/

B. Elimination of the Exemption from Registration for Securities Guaranteed by Banks

The apparent competitive disparity between banks and insurance companies could be remedied by removing the exemption for securities guaranteed by banks. The Commission has considered two means of removing the exemption: legislative amendment of Section 3(a)(2), as recommended by the Bush Task Group, or administrative reinterpretation of that Section.

1. Amendment of Section 3(a)(2): the Bush Task Group Proposal

The Commission believes that any competitive disparity that may exist can be resolved through enactment of the Bush Task Group

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244/ See Commission hearing at 26 (statement of Weill).

245/ See, e.g., Securities Exchange Act Rel. No. 23924 (Dec. 22, 1986) (Commission order exempting Home Savings of America, F.A. from certain requirements under Section 13 and 15(d) and the operation of Section 16 of the Securities Exchange Act).

recommendation to amend Section 3(a)(2) of the Securities Act to require registration of publicly-offered securities of banks and thrifts (but not deposit instruments). Under the Bush Task Group recommendation, securities backed by bank standby letters of credit and other bank guarantees would no longer be exempt from the registration provisions of that Act, although registration of the letter of credit itself would not be required. Enacting this recommendation would accord the financial guarantee activities of banks and insurance companies essentially equivalent treatment under the Securities Act, and at the same time address the investor protection concerns created by the Section 3(a)(2) exemption for securities guaranteed by banks.

Vice President Bush's Task Group on Regulation of Financial Services was formed in 1982 to address problems arising from the blurring of the lines between the banking and securities industries and overlapping, excessive, and conflicting regulations of agencies with jurisidiction over the financial services industries. The members of the group consisted of the heads of key financial regulatory agencies, including the Commission. The Task Group's recommendations were adopted unanimously in 1984. 246/ Subsequently, the Commission strongly endorsed the securities law recommendations of the Task Group in testimony before a Subcommittee of the House

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246/ Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services (July 2, 1984) ("Task Group Report").

Committee on Government Operations in 1985, 247/ and approved a legislative draft implementing those recommendations on July 10, 1986.

One of the central concerns of the Task Group was that differential regulation under the current regulatory structure can result in inequitable treatment of firms competing in the same market, as well as possibly differing levels of protection of the public. Thus, the Task Group noted, permitting banks and thrifts to offer securities for sale to the public, without registration with the Commission under the Securities Act, can result in unfair treatment of investors who may not be aware of this potential gap in regulatory protection. 248/ Accordingly, the Task Group recommended that the registration requirements of the Securities Act be made applicable to publicly-offered securities (but not deposit instruments) of banks and thrifts, as is generally the case for securities of other types of entities. 249/

247/ Bush Task Group Report on Regulation of Financial Services: Blueprint for Reform: Hearings before a Subcommittee of the House Committee on Government Operations, 99th Cong., 1st Sess. 104 (Part 1) (1985). Commissioner Peters submitted a statement stating separate views, but concurred as to amendment of Section 3(a)(2). Id. at 132.

248/ Task Group Report at 28.

249/ The House Subcommittee on Oversight and Investigations recently recommended legislation substantially similar to the Bush Task Group recommendation on the treatment of bank and thrift securities. See House Subcomm. on Oversight and Investigations of the Committee on Energy and Commerce, 100th Cong., 1st Sess., Consolidating the Administration and Enforcement of the Federal Securities Laws within the Securities and Exchange Commission (Comm. Print 1987).

The legislation to enact the Bush Task Group proposals has been introduced in Congress as Subtitle H of Title IV of the "Trade, Employment, and Productivity Act of 1987." 250/ Under that legislation, securities guaranteed by banks or backed by bank letters of credit would no longer be exempt. 251/ Thus, the financial guarantee activities of banks and insurance companies would be treated alike: the primary security would be required to be registered, while the credit enhancement would not. The Commission believes enactment of the Bush Task Group proposal would effectively address the concerns of financial guarantee insurers concerning any competitive advantage enjoyed by banks in the corporate debt market.

In addition to ending any competitive disparity, enactment of the proposal would also address the investor protection concerns created by the Section 3(a)(2) exemption for securities guaranteed by banks. These concerns are essentially the same as the ones created by the proposed exemption for securities guaranteed by insurance policies. Bank regulation, like insurance regulation, is designed to permit safe and sound operation of the regulated entities. 252/ It is not a substitute for the registration provisions of the Securities Act or the periodic reporting provisions of the Securities Exchange Act.

250/ S. 539.

251/ The letters of credit themselves, however, would not be required to be registered. *See* S. 539, 100th Cong., 1st Sess. § 4831(a), (d) (1987).

252/ As discussed *supra* p. 25, standby letters of credit are not subject to federal deposit insurance.

While bank regulation does require disclosure of financial information in bank reports of condition, that information is not required to be provided to investors, as a prospectus is, nor do the liability provisions of Section 11 attach to those reports. Moreover, banking regulation does not ensure that the marketplace receives adequate information concerning other material aspects of offerings, such as the terms of the security being sold.

Several commentators argued that the exemption for securities guaranteed by banks should be preserved, indicating that they were unaware of any defaults on bank standby letters of credit backing publicly-held securities. 253/ This limited evidence is not determinative as to whether the exemption for securities guaranteed by banks should be repealed. This evidence is based largely on

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253/ See Financial Security Assurance letter at 2 ("There is no evidence that investors have failed to receive scheduled payments of principal and interest on any bank-guaranteed security which was exempt from registration under Section 3(a)(2) of the '33 Act"); New York Clearing House letter at 9 ("[T]he Clearing House is not aware of any case in which investors have suffered a loss on bank guaranteed securities that were distributed to the public"). See also letter from John B. Sprung, Senior Vice President and General Counsel, Merrill Lynch Money Markets Inc., to Jonathan G. Katz, Secretary, SEC, dated March 13, 1987, at 2 (indicating no unfulfilled obligations under bank standby letters of credit in offerings over the last five years).

While banks with outstanding claims on letters of credit have been placed in receivership, resulting in losses to beneficiaries, see First Empire Bank-New York v. FDIC, 572 F.2d 1361 (9th Cir.), cert. denied, 439 U.S. 919 (1978); FDIC v. Liberty Nat'l Bank & Trust Co., 806 F.2d 961 (10th Cir. 1986), those banks apparently had not backed publicly-held securities.

past letter of credit activity, when the extent and nature of bank standby letter of credit activity were very different from today. Moreover, the lack of defaults does not establish that the market has been provided with adequate information that would allow accurate pricing of these unregistered securities.

2. Statutory Construction of Section 3(a)(2) to Require Registration of Securities Backed by Bank Standby Letters of Credit

Reversal of the Commission's interpretive position that Section 3(a)(2) exempts securities backed by bank standby letters of credit would require registration of securities backed by standby letters of credit if they were offered to the public. The Commission believes, however, that its long-standing interpretation of Section 3(a)(2) is correct as a matter of statutory construction. Moreover, because certain state banks have the power to issue guarantees, reversal of the interpretation would not completely resolve any competitive disparity that may exist.

Any reinterpretation of Section 3(a)(2) would turn on the meaning of "guarantee." At the time the Securities Act was enacted banks rarely guaranteed publicly-held securities. In fact, most banks, it was believed, generally lacked the power to do so. 254/ One rationale justifying the issuance of standby letters of credit by national banks, as distinguished from suretyship (which such banks generally cannot undertake), is that the former involves a primary obligation to make payments when presented

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254/ *See supra* p. 13.

with appropriate documents, rather than a secondary obligation. 255/ Based on this banking law distinction between standby letters of credit and guarantees, it could be argued that standby letters of credit are not guarantees under Section 3(a)(2) and the interpretive position previously taken with regard to securities backed by standby letters of credit should be reversed.

The Commission continues to believe, however, that such an approach would be inconsistent with the statutory language and intent of Section 3(a)(2). Irrevocable standby letters of credit provide security holders with as much protection as guarantees and are "tantamount to guarantees by [a] bank." 256/ Thus, a security backed by a bank standby letter of credit is a security guaranteed by a bank, within the meaning of Section 3(a)(2).

As discussed above, payment under a standby letter of credit must be conditioned upon the presentment of documents. 257/ If the appropriate documents are presented, only limited defenses are

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255/ See supra p. 14.

256/ Merrill Lynch, Pierce, Fenner & Smith, Inc. (Division of Corporation Finance no-action letter avail. May 3, 1982).

257/ In the case of a letter of credit backing a security, typically those documents are a draft, accompanied by a default certificate or the debt instrument or both. See Ryan, supra note 41, at 474; FDIC v. Liberty National Bank & Trust Co., 806 F.2d 961, 964 (9th Cir. 1986); see also Official Comment (1) to UCC § 5-102 (accompanying papers may be "a notice of default of some kind"); UCC § 5-103(1)(b) ("'Document' means any paper including * * * [a] certificate, notice of default and the like").

available to block payment on the letter of credit. 258/ Thus, although the obligation of the bank is independent from the underlying contract in the sense that performance is conditioned upon presentment of documents, as a practical matter, a standby letter of credit provides at least as much protection as a guarantee.

Moreover, reinterpreting the guarantee provision of Section 3(a)(2) to exclude standby letters of credit would not place the financial guarantee activities of all banks on a par with the activities of insurance companies. Certain state banks have the power to issue guarantees. For example, Section 96.9 of the New York Banking Law authorizes state-chartered banks to issue "such guaranties as may be incidental to carrying on the business of a bank." 259/ Thus, reinterpreting Section 3(a)(2) would still allow certain state banks to issue credit enhancements exempting the underlying security from the Securities Act, creating a new competitive disparity between certain state banks, on the one hand, and national banks and insurers, on the other.

C. General Exemptive Authority

Certain classes of or transactions in guaranteed securities may not require the full protection of the Securities Act. The

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258/ *See supra* p. 18.

259/ *See also* 17 Mich. Stat. Ann. § 23.710(151)(Callaghan Supp. 1986)(virtually the same as New York); Pa. Stat. Ann. tit. 7, § 313 (Purdon Supp. 1986)(allowing such guarantees as may be approved by regulation).

Commission therefore, reiterates its support for the Bush Task Group recommendation to give the Commission authority to grant exemptions from the registration requirements of the Securities Act for those securities or securities transactions for which registration is unnecessary.

Under that recommendation, the Commission would have authority to exempt from the registration provisions of the Act, by rule or order, securities or securities transactions, where necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the Securities Act. 260/ The Commission currently has exemptive authority under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Similar flexibility would be desirable under the Securities Act. The Commission deals with a variety of situations in which registration under the Act may not be necessary. To the extent that the full protections of the Act might not be necessary for certain transactions or classes of guaranteed securities the Commission could use exemptive authority to fashion appropriate relief.

VII. CONCLUSION

The exemption in Section 3(a)(2) of the Securities Act for securities guaranteed by banks creates an apparent advantage for banks competing with insurance companies for financial guarantee

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260/ See S. 539, Title IV, Subtitle H, Part 7, § 4831(f).

business. The most desirable response to any competitive disparities, however, is not to create a new legislative exemption targeted at certain securities guaranteed by insurance. The Commission believes that any competitive disparities that may exist can be resolved through two approaches, both of which are consistent with investor protection and the public interest, and with the recommendations of the Bush Task Group. The Commission recommends that Congress amend Section 3(a)(2) to remove the exemption from registration for securities issued or guaranteed by banks. This recommendation would place the financial guarantee activities of banks and insurance companies on an equal footing under the Securities Act. The Commission also recommends that Congress provide the Commission with authority to grant exemptive relief from the registration requirements of the Securities Act. Such exemptive authority would allow the Commission to rectify any inequities that may exist as well as to respond to evolving market conditions that may warrant such exemptions as are consistent with the investor protection, the public interest, and the purposes of the Act.

EXHIBIT A

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 230

[Release No. 33- 6688 ; File No. S7-2-87]

Request for Comments on the Use of the Exemption in Section 3(a)(2) of the Securities Act of 1933 for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities.

AGENCY: Securities and Exchange Commission

ACTION: Request for Comments

SUMMARY: The Commission solicits comments on the use of the exemption in Section 3(a)(2) of the Securities Act of 1933 for securities guaranteed by banks and the use of insurance policies to guarantee securities. This request is part of a Commission study mandated by the Government Securities Act of 1986 (Pub. L. No. 99-571) (the "Act"). As provided by the Act, the study will be conducted in consultation with the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, and other federal bank regulatory agencies. The study is to be completed by April 28, 1987 (six months after the date of enactment of the Act).

The Commission will hold a public hearing during the course of the study. Interested individuals and organizations will have an opportunity to discuss their views on the topics covered in this release.

DATES: Comments are to be received by March 13, 1987. The public hearing is tentatively scheduled for March 23, 1987, 1:30 p.m. at the Public Meeting Room (Room IC-30) of the Securities and Exchange Commission in Washington, D.C., 450 Fifth Street, N.W. Individuals or organizations wishing to present their views at the public hearing should contact the Commission officials listed below by March 9, 1987.

ADDRESS: Persons wishing to submit comments should file three copies with Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. All comments should refer to File No. S7-2-87 and will be available for inspection at the Commission's Public Reference Room.

FOR FURTHER INFORMATION CONTACT: Matthew A. Chambers, Esq., (202)272-2428, Office of the General Counsel, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:

I. SECTION 105 OF THE GOVERNMENT SECURITIES ACT OF 1986

Section 105 of the Government Securities Act of 1986 directs the Commission to perform a "study of the use of the exemption contained in [S]ection 3(a)(2) of the Securities Act of 1933 (15 U.S.C. 77c(a)(2)) for securities guaranteed by banks, and the use of insurance policies to guarantee securities." As directed

by Congress, the study will focus on:

(1) the impact of the guarantee provision of the exemption in Section 3(a)(2) of the Securities Act on investor protection and the public interest;

(2) the impact of the guarantee provision of Section 3(a)(2) on competition between banks and insurance companies and between domestic and foreign guarantors;

(3) whether, and under what circumstances, debt securities guaranteed by insurance policies should be exempt from registration under the Securities Act;

(4) the impact of such an exemption on investor protection and the public interest; and

(5) such other issues as the Commission deems relevant.

II. BACKGROUND

A "financial guarantee" is defined, generally, as a third party's guarantee, for a fee, that another party's obligations in a financial transaction will be met. Financial guarantees first gained widespread acceptance in the 1970s to insure payment of principal and interest on municipal bonds. Since that time, they have been used to back issues of corporate bonds, commercial paper, limited partnerships, and debt securities backed by assets (including mortgages, automobile loans, and credit card receivables.) 1/ The entities engaging in the financial guarantee

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1/ Freedman, Financial Guarantees: Too Hot to Handle? 86 Best's Rev. (Property/Casualty Insurance Edition) 16, 133 (Oct. 1985).

(Footnote continued)

business include insurance companies and domestic and foreign banks. 2/

Insurance companies entered the financial guarantee market with municipal bond insurance. In that market, a municipality with a low credit rating in a debt offering purchases an insurance policy to insure payment of principal of and interest on its bonds. 3/ The guarantee raises the market's perception of the creditworthiness of the municipality's obligation, gives the municipality more access to credit, and allows it to pay lower interest rates to investors. The guarantor charges a premium or fee which the municipality is willing to pay because the cost

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1/ (Continued footnote)

See also Haine, Developments in Financial Guarantee Insurance, Bus. Law. Update, Nov.-Dec. 1986, at 5.

Financial guarantees may also be used to provide credit support to demand agreements relating to variable or floating rate instruments, such as variable rate tax-free municipal bonds. The demand feature may enable such an instrument to be treated as short-term debt, and the credit support of the demand feature may raise the quality of an instrument and, thus, make it marketable to tax-free money market funds that invest only in high quality short-term instruments. See Investment Company Act Release No. 14983 (March 12, 1986).

2/ In addition to insurance companies and banks, industrial companies, consortiums of financial institutions, and other financial intermediaries have entered the financial guarantee market. See Freedman, supra note 1, at 18; Registration Statement of General Electric Credit Corporation on Form S-3, File No. 2-80000 (filed Oct. 27, 1982) (registration of standby letter of credit in connection with exempt municipal bond offering).

3/ Sometimes the insurance is purchased by another party, such as the sponsor of a unit investment trust, to cover securities in the trust's portfolios. Such insurance may be applicable only so long as the insured security is held by the unit investment trust. The insurance allows the trust to get a higher rating for its portfolio as a whole.

will be recovered through the difference between the insured rate of interest and the interest rate that would be paid without the guarantee. 4/

The use of municipal bond insurance has grown rapidly. According to one estimate, financial guarantees backed 20% of long-term debt issued by municipalities in 1985 as compared to 3% in 1980. 5/ As of mid-1985, it was estimated that municipal bond insurers had guaranteed a cumulative $125 billion to $150 billion in principal and interest and collected $750 million to $1 billion in premiums. 6/

Insurance companies also underwrite guaranteed investment contracts ("GICs") in connection with the issuance of publicly held debt securities. 7/ Like an insurance policy, a GIC allows

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4/ Freedman, *supra* note 1, at 16.

5/ *Insurers and SEC Battle Over Measure to Alter Debt-Registration Requirement*, Wall St. J., Sept. 29, 1986, at 24.

6/ Brenner, *Booming Financial Guarantees Market Generates Profits - and Some Questions*, Am. Banker, June 24, 1985, at 1.

7/ A GIC may take any of a variety of forms. Nearly all, however, are deferred annuities issued by insurance companies under which the purchaser agrees to pay money to an insurer (in one or more installments), and the insurer promises to pay interest at a guaranteed rate for the life of the contract. In some contracts, the insurer may periodically pay discretionary excess interest over and above the guaranteed rate.

The insurer may tailor the terms of the GIC to meet the needs of the individual bond issuer. In general, however, the arrangement usually includes two annuity forms - a single premium deferred annuity and a single premium immediate

(Footnote Continued)

a municipality to borrow at a lower cost.

Domestic banks participate in the financial guarantee market primarily through the use of standby letters of credit. 8/ These standby letters of credit are considered by some to be

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7/ (Continued footnote)

annuity. Under the deferred annuity, benefit payments do not begin until the end of an initial period during which funds are accumulated at compound interest with the insurance company. In contrast, benefit payments under the immediate annuity begin at the end of the first payment interval after purchase (e.g., if payments were to be made on a monthly basis, the first payment would be made at the end of the first month following purchase of the contract).

In a taxable municipal bond offering backed by GICs, a portion of the total proceeds is invested in a GIC of the single premium immediate annuity type as a debt service reserve fund and used to provide money to pay the interest on the bonds. The remainder of the bond proceeds is invested initially in a GIC of the single premium deferred annuity type that contains full and partial surrender clauses that permit the municipality to draw on the GIC to finance its municipal operations.

8/ In general, state and national banks have traditionally lacked the power, under state and federal law, respectively, to guarantee the payment of indebtedness. See Verkuil, Bank Solvency and Guaranty Letters of Credit, 25 Stan. L. Rev. 716, 725 & n.44 (1972-1973); Comment, Recent Extensions in the Use of Commercial Letters of Credit, 66 Yale L.J. 902, 911-12 & n.38 (1956-1957); Harfield, The National Bank Act and Foreign Practices, 61 Harv. L. Rev. 782, 788 & n.12 (1947-1948). The Office of the Comptroller of the Currency has determined, nevertheless, that national banks generally are empowered to issue standby letters of credit. See 12 C.F.R. 7.7016 (1986). Because letters of credit bear some resemblance to guarantees, however, the question often arises as to whether a particular letter of credit is an impermissible guarantee. See, e.g., Letter No. 295 (July 3, 1984) (interpretative letter issued by the Office of the Comptroller of the Currency).

functionally equivalent to insurance policies. 9/ One source estimated that, in 1984, United States commercial banks issued standby letters of credit guaranteeing total debt of $146 billion, up from $46.8 billion in 1980. 10/ Bank fees for standby letters of credit in 1984 were estimated to be $730 million. 11/

Foreign banks also have entered the financial guarantee market. According to one estimate, in mid-1985, United States branches and agencies of foreign banks had $20.7 billion in standby letters of credit outstanding. 12/ More recently, it was estimated that foreign banks had increased their share of the domestic market for standby letters of credit to over 50%. 13/

III. TREATMENT OF FINANCIAL GUARANTEES UNDER THE SECURITIES ACT OF 1933

Under the Securities Act of 1933, public offerings of securities must be registered unless an exemption from the registration requirements is available. Under Section 2(1) of the Securities Act, a guarantee of a security is a separate security; the guarantee

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9/ See Letter to Patrick Mulhern, Senior Vice President and General Counsel, Citibank, N.A. from Michael Patriarca, Deputy Comptroller for Multinational Banking, Office of the Comptroller of the Currency, May 2, 1985 (concurring in opinion that national bank may acquire or establish municipal bond insurance subsidiary).

10/ Brenner, Regulators Worry About Guarantees, Am. Banker, June 26, 1985, at 17.

11/ Id. at 18.

12/ Brenner, supra note 10, at 17.

13/ Wong, Foreign Banks Grab a Market Segment, Wall St. J., December 15, 1986, at 6.

also must be registered unless an exemption from registration is available. Financial guarantees in the forms of bank standby letters of credit and insurance policies, however, have generally not been registered, in reliance on Sections 3(a)(2) and 3(a)(8) of the Act.

Financial guarantees issued by domestic banks in the form of standby letters of credit are exempt from registration pursuant to Section 3(a)(2) of the Securities Act, which exempts "any security issued * * * [by] any national bank, or any banking institution organized under the laws of any State, Territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official * * *." In addition, Section 3(a)(2) exempts from registration "any security * * * guaranteed by" such a bank. Although a standby letter of credit may be deemed not to be a guarantee for some purposes, but rather an "engagement * * * [of] the issuer [to] * * * honor drafts or other demands for payment upon compliance with the conditions specified," 14/ the Commission's Division of Corporation Finance has treated standby letters of credit as being "tantamount to guarantees by [a] bank." Thus, the security backed by the letter of credit and the letter of credit itself have not been registered under the Securities Act. 15/

14/ U.C.C. § 5-103.

15/ Merrill Lynch, Pierce, Fenner & Smith, Inc. (May 3, 1982) (Division of Corporation Finance no-action letter).

In September 1986, the Commission issued an interpretive release setting forth its position on the application of the Section 3(a)(2) exemption to securities issued or guaranteed by United States branches and agencies of foreign banks. 16/ In that release, the Commission announced that it deemed a branch or agency of a foreign bank located in the United States to be a "national bank," or a "banking institution organized under the laws of any state, territory, or the District of Columbia," within the meaning of Section 3(a)(2), provided that the nature and extent of federal and/or state regulation and supervision of the particular branch or agency is substantially equivalent to that applicable to federal or state chartered domestic banks doing business in the same jurisdiction. Thus, a security backed by a standby letter of credit or otherwise "guaranteed" by a domestic branch or agency of a foreign bank subject to regulation substantially equivalent to that applicable to a domestic bank is exempt from registration under the Securities Act. 17/

Insurance companies providing financial guarantees backing debt securities have not registered the guarantees in reliance on

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16/ Securities Act Release No. 6661 (Sept. 23, 1986).

17/ The Commission also stated that the determination whether the requirement of substantially equivalent regulation was met was one which must be made by the particular branch or agency and its counsel. Id. See also Investment Company Act Release No. 15314 (Sept. 17, 1986) for a discussion of the treatment of foreign banks under the Investment Company Act of 1940.

Section 3(a)(8) of the Securities Act. That Section provides an exemption from registration for certain insurance policies and annuity contracts regulated by state insurance commissioners. 18/ Although phrased as an exemption, the Commission has taken the position that Section 3(a)(8) provides an exclusion from all provisions of the Securities Act. 19/

An insurance company guarantee of principal of and interest on a tax-exempt municipal bond has been deemed to be exempt under Section 3(a)(8) of the Securities Act. 20/ Similarly, an insurance company's financial guarantee bond insuring the timely payment of

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18/ Although the guarantee is exempt from registration, under Rule 3-10 of Regulation S-X (the Commission's regulation prescribing the form and content of financial statements filed with the Commission), the financial statements of the guarantor must be filed as part of the registration statement concerning the guaranteed securities.

On February 5, 1987, the Commission voted to repropose Form N-7, a form for registration of unit investment trusts under the Investment Company Act and the Securities Act. As reproposed, the form would require unit investment trusts whose portfolios are insured or guaranteed to include financial statements of the insurer or guarantor in their registration statements.

19/ Securities Act Release No. 6558 (Nov. 21, 1984). Furthermore, an instrument that is described in Section 3(a)(8) of the Securities Act has been held not to be a security subject to the antifraud provisions of the Securities Exchange Act of 1934. See Otto v. Variable Annuity Life Ins. Co., [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,012 (7th Cir. Dec. 8, 1986). In contrast, bank issued or guaranteed securities, while exempted from registration under the Securities Act and from the provisions of Section 12(2) of that Act, have not been considered to be excluded from the provisions of Section 17 of the Securities Act nor exempted or excluded from the provisions of the Securities Exchange Act of 1934.

20/ American Municipal Bond Assurance Corp. (June 16, 1972) (Division of Corporation Finance no-action letter).

amounts due under debentures to be offered publicly by a non-insurance subsidiary of an insurance company has also been treated as exempt under Section 3(a)(8). 21/

Not every instrument labeled as an insurance policy or an annuity contract, however, falls within the exclusion of Section 3(a)(8). For example, a variable annuity contract in which the entire investment risk remains with the annuity holder is deemed not to be an annuity contract for purposes of Section 3(a)(8). 22/ Similarly, variable annuity contracts in which the investment risks borne by the respective insurance companies are not deemed significant also are not considered to be annuity contracts for purposes of Section 3(a)(8). 23/

The Commission has adopted Rule 151 under the Securities Act, which establishes a "safe harbor" within Section 3(a)(8) for certain types of annuity contracts. 24/ To come within the Rule,

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21/ Sentry Financial Services Co. (Jan. 5, 1977) (Division of Corporation Finance no-action letter).

22/ Securities and Exchange Commission v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959).

23/ Securities and Exchange Commission v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); Peoria Common Stock Yards Co., v. Penn. Mutual Life Ins. Co., 698 F.2d 320 (7th Cir. 1983); cf. Otto v. Variable Annuity Life Ins. Co., [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,012 (investment risk assumed by insurer deemed sufficient for instrument to be considered an annuity contract for purposes of Section 3(a)(8) of the Securities Act, and, hence, for the instrument not to be a security for purposes of the Securities Exchange Act of 1934).

24/ Securities Act Release No. 6645 (May 29, 1986).

the contract must (1) be issued by a corporation subject to the supervision of the state insurance commissioner, bank commissioner, or any agency or officer performing like functions, (2) include guarantees of principal and interest sufficient in degree for the issuer to be deemed to have assumed the investment risk, and (3) not be marketed primarily as an investment. While compliance with Rule 151 will assure "non-security status," failure to comply does not necessarily result in the annuity contract being denominated a security outside the Section 3(a)(8) exclusion. The Commission, however, has taken the position that the rationale underlying the conditions set forth in the rule is relevant to any Section 3(a)(8) determination. 25/

Thus, under the Securities Act, any security guaranteed by a bank, and the guarantee itself, are exempt from the registration requirements and from the private liability provisions of Section 12(2). Both the guaranteed security and the guarantee itself, however, are subject to the antifraud provisions of Section 17. 26/ Insurance policies that guarantee securities are excluded from the Act in its entirety if those policies come within Section 3(a)(8). Securities guaranteed by insurance policies, however, generally are subject to all of the Securities Act's

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25/ Id. The Court of Appeals for the Seventh Circuit has found Rule 151 "helpful" in determining the securities law status of an annuity contract that predated the Rule. Otto v. Variable Annuity Life Ins. Co., [Current] Fed. Sec. Law R. (CCH) ¶ 93,012.

26/ Section 17(c) of the Securities Act.

requirements, including the registration requirements of Section 5, unless a separate exemption applies. 27/

IV. REQUEST FOR COMMENT

Congress directed the Commission to examine the impact of the exemption in Section 3(a)(2) for securities guaranteed by banks on investor protection and the public interest and on competition among guarantors, and whether a similar exemption from registration should be provided for securities guaranteed by insurance policies. For ease of discussion and to focus the responses of commentators, the discussion set forth below has been divided into three sections. The first section concerns the use of the exemption in Section 3(a)(2) and its impact on investor protection and the public interest; the second, the impact of that exemption on competition among banks and insurance companies, and domestic and foreign guarantors; and the third, whether and under what circumstances debt securities guaranteed by insurance policies should be exempt from registration. Of course, many of the issues to be addressed are interrelated, and commentators need not structure their answers to conform to this organization. In responding to the issues discussed below, the Commission requests that commentators be as specific as possible, and, where appropriate, provide quantitative data and cite to the source of

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27/ For example, municipal bonds generally are exempt under Section 3(a)(2), and commercial paper generally is exempt under Section 3(a)(3).

the data. The Commission also invites commentators to address any other matters that they believe are relevant to the study.

A. The Use of the Guarantee Provision of the Exemption in Section 3(a)(2) and its Impact on Investor Protection and the Public Interest.

In evaluating the use of the guarantee provision of the exemption in Section 3(a)(2) and its impact on investor protection and the public interest, the Commission requests information on the market for securities guaranteed by banks, the banking regulatory scheme currently applicable to standby letters of credit and other financial guarantees issued by banks, the rights of security holders under standby letters of credit, and the record of those banks that have issued guarantees.

As noted above, banks are major participants in the financial guarantee market. The Commission requests that the commentators address the nature and extent of bank participation in that market, with particular emphasis on guarantees of publicly offered securities. What specific types of securities are being offered with standby letter of credit backing? What is the volume of these offerings by type of security? What are the current trends in this market, and what future developments are likely? What types of banks are issuing standby letters of credit in connection with public offerings?

The Commission believes that the impact of the guarantee provision in Section 3(a)(2) should be assessed in light of the current banking regulatory scheme. While the legislative history of the Section 3(a)(2) exemption for securities issued

or guaranteed by banks is relatively sparse, that history indicates that the exemption was provided because it was believed at the time that the existing bank regulatory authorities exercised "adequate supervision over the issuance of [bank] securities * * *." 28/ The legislative history does not separately examine the rationale for the guarantee provision, or address the extent to which banks were issuing financial guarantees at that time.

State and federal banking authorities regulate the issuance of standby letters of credit by banks. For example, letters of credit issued by national banks and state member banks are deemed to be extensions of credit and are subject to lending limits. 29/ In addition, the volume of standby letters of credit issued by a bank may affect capital requirements. 30/ The Commission requests

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28/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 14 (1933). In addition, the drafters of the legislation that became the Securities Act believed that it would be unnecessarily duplicative to require entities that filed information with bank regulators regarding the issuance of securities to file the same information with a second agency. See Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 29-30 (1933)(statement of Huston Thompson).

29/ See, e.g., 12 C.F.R. 208.8 (Board of Governors of the Federal Reserve System regulations requiring that standby letters of credit must not, when combined with other extensions of credit, exceed lending limits imposed by state law and limits on loans to affiliates under federal law); 12 C.F.R. Part 32 (Office of the Comptroller of the Currency regulations).

30/ See, e.g., 12 C.F.R. 3.10 (Office of the Comptroller of the Currency regulations pertaining to national banks stating that "higher capital ratios may be appropriate for * * * [a] bank having a high proportion of off-balance sheet risks,

(Footnote Continued)

that commentators address the relationship of these banking regulatory requirements and policies to the investor protection concerns of the Securities Act. In particular, are these banking law requirements adequate substitutes for the full disclosure requirements of the Securities Act? Do bank regulators impose any other requirements on bank issuances of financial guarantees?

As noted above, foreign banks apparently have greatly increased their financial guarantee activity in recent years. The Commission requests that commentators address the domestic banking regulations applicable to branches or agencies of foreign banks located in the United States, and any differences between the regulation of domestic banks and domestic branches and agencies of foreign banks in this market. 31/

30/ (Continued footnote)

especially standby letters of credit"); Agreed Proposals of the United States Federal Banking Supervisory Authorities and the Bank of England on Primary Capital and Adequacy Assessment, January 8, 1987 (proposed framework for capital requirements treating off-balance sheet items such as financial guarantees and equivalents, including standby letters of credit, as requiring greater levels of capital).

Standby letters of credit are not insured as deposits under the federal deposit insurance program. Federal Deposit Ins. Corp. v. Philadelphia Gear Corp., 106 S. Ct. 245 (1986).

31/ As discussed above, the Commission in Securities Act Release No. 6661 interpreted the Section 3(a)(2) exemption as applying to branches or agencies of foreign banks located in the United States, provided that the nature and extent of federal and/or state regulation and supervision of the particular branch or agency is substantially equivalent to that applicable to federal or state chartered domestic banks doing business in the same jurisdiction. Thus, a standby letter of credit or other "guarantee" issued by a branch or agency of a foreign bank not subject to substantially equivalent regulation and supervision, and the security backed by such a letter of credit or guarantee, are not within the exemption in Section 3(a)(2).

The Commission also requests comment on the rights of security holders under bank standby letters of credit and other bank financial guarantees. Are such rights uniform across all standby letters of credit? Does a bank have any defenses against the calling down of a standby letter of credit backing a publicly-held security? For example, if a letter of credit were procured by fraud on the part of the issuer of the security, is the bank nonetheless obligated to security holders? How promptly must payment on the letter of credit be made?

Finally, the Commission asks that commentators address the experience with securities backed by bank guarantees. How often have issuers defaulted and banks been called upon to honor guarantees? Have any banks been unable to fulfill, or sought to avoid, their commitments? Is past history an adequate guide to future events in light of the rapid growth in this market in recent years?

B. The Impact of the Guarantee Provision in Section 3(a)(2) on Competition.

As noted above, under Section 3(a)(2) of the Securities Act, securities guaranteed by banks are exempt from registration, but securities guaranteed by insurance polices are not. Insurance companies have argued that this difference in regulation creates an unfair and unjustified competitive disparity. 32/ It has been

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32/ See, e.g., Letter to Sen. Alfonso M. D'Amato from W. James Lopp, Chairman and President, Financial Security Assurance, dated February 14, 1986.

said that this disparity "makes it virtually impossible for insurance companies to provide cost-effective coverage to issuers." 33/ To evaluate the impact of the exemption for securities guaranteed by banks on competition between these guarantors, the Commission requests information on the guarantee markets in which domestic banks, foreign banks, and insurance companies compete, the bases on which guarantors compete, and how the guarantee provision in Section 3(a)(2) affects competition.

The Commission requests that commentators provide information on the financial guarantee markets in which the guarantors compete. The Commission requests data on market shares of domestic banks, foreign banks, and insurance companies among each type of security backed by these guarantors, and the current trends in the markets.

The Commission also requests comment on the bases of the competition among the various types of guarantors. Clearly, the price paid by the issuer for the guarantee and the borrowing savings to the issuer are important factors in that competition. According to some reports, far more insurance companies have received AAA ratings in connection with their financial guarantee business than have banks, which would seem to give those insurance companies a significant competitive advantage. 34/ Does the Section 3(a)(2) guarantee provision significantly affect competition

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33/ 132 Cong. Rec. S 15797 (daily ed. Oct. 9, 1986) (statement of Sen. D'Amato).

34/ Freedman, supra note 1, at 16.

by allowing banks to offer issuers an exemption from registration? The Commission also requests information on the costs attributable to the registration process and whether the registration of a security results in any savings to the issuer.

It has been said that letters of credit and insurance policies are functionally equivalent. Are there differences in function between these guarantees, and how does the difference affect competition? Are there any differences between the defenses that may be raised to insurance company liability on an insurance guarantee, such as fraud on the part of the issuer of an insured security, and the defenses that may be raised to bank liability on a standby letter of credit?

The Commission requests that commentators address the similarities and differences in the banking and insurance regulatory schemes, as they affect the competition between domestic banks, domestic branches and agencies of foreign banks, and insurance companies. For example, federal banking regulators have recently proposed increased capital requirements for banks that incur off-balance sheet liabilities, including standby letters of credit. 35/ It appears that risk-based capital requirements would impose additional costs on banks that guarantee securities, which could affect those banks' ability to compete with other guarantors.

35/ *See, e.g.*, 51 Fed. Reg. 10602-01 (March 27, 1986) (advance notice of proposed rulemaking published by the Office of the Comptoller of the Currency regarding risk-based capital standards).

The Commission requests that commentators address how any significant competitive disparity created by the exemption in Section 3(a)(2) should be addressed. Vice President Bush's Task Group on Regulation of Financial Services, which included the heads of all the bank and other federal agencies that regulate financial services, recommended that the registration requirements of the Securities Act be made applicable to publicly offered securities of banks and thrifts (but not deposit instruments). A logical consequence of the Bush Task Group recommendation is that Section 3(a)(2) of the Securities Act must be amended to delete the current exemption for securities guaranteed by a bank. Commentators are requested to address whether enactment of the Bush Task Group proposal is the appropriate means of eliminating any competitive disparity caused by the guarantee provision of Section 3(a)(2).

Alternatively, commentators are asked to consider whether the Commission should revisit the position taken by the Commission's Division of Corporation Finance in no-action letters concerning securities backed by bank standby letters of credit. That is, should it reconsider whether a security backed by a bank standby letter of credit is a security "guaranteed" by a bank, within the meaning of Section 3(a)(2) of the Securities Act?

As noted above, national banks generally lack the power to guarantee the debts of others, but the issuance of standby letters of credit has been determined to be a permissible activity. Commentators should address the extent to which state banks and

domestic branches and agencies of foreign banks may guarantee the debts of others. If such entities do have that power, and the Commission reinterpreted the term "guarantee" to exclude standby letters of credit, securities guaranteed by those entities would not be required to be registered, while securities backed by national banks and insurance companies would be required to be registered.

C. Should Debt Securities Guaranteed by Insurance Policies be Exempt from Registration under the Securities Act?

In evaluating whether debt securities guaranteed by insurance policies should be exempt from registration under the Securities Act, the Commission requests information on the regulatory scheme governing financial guarantee insurance, the types of financial guarantee insurance available, the market for securities guaranteed by such insurance, the experience of those companies that have issued such guarantees, and the conditions, if any, that should form the bases for such an exemption from registration.

Regulation of the business of insurance is generally conducted within the parameters of state insurance regulation. 36/ Under the leadership of the National Association of Insurance Commissioners

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36/ The McCarran-Ferguson Act, 15 U.S.C. 1011-1015, provides that no act of Congress shall be construed to invalidate, impair or supersede any law enacted by any state for the purpose of regulating the business of insurance, unless such act specifically relates to the business of insurance. The Act does not preclude the Commission, however, from administering the federal securities laws with respect to a security simply because the security is promoted or issued by an insurance company. Securities and Exchange Commission v. National Securities, Inc., 393 U.S. 453 (1969).

(the "NAIC"), the states have passed laws to supervise and control the business of insurance, and, in particular, the financial solvency of insurance companies. Financial guarantee insurance, however, does not appear to be extensively regulated by the states. 37/ The NAIC recently adopted a Model Act which may serve as a basis for state regulation of this type of insurance. 38/ Several states, including New York and Virginia, plan to introduce legislation based substantially on the NAIC model. However, it is unclear whether these states and others will adopt the proposal in whole or in part, or reject it and develop their own scheme of regulation.

The Commission seeks comment on how states define financial guarantee insurance, whether and to what extent such insurance is subject to capital, surplus, and contingency reserve requirements, the nature of the risk assumed, how the product is priced, 39/ the nature of any limitations and restrictions imposed on the

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37/ What is Behind the Bittersweet Boom in Financial Guarantees, Bus. Wk., Sept 17, 1984, at 116; Statement of James P. Corcoran, Superintendent of Insurance of the State of New York on Financial Guaranty Insurance, Before Assembly Committee on Insurance, October 1, 1986.

38/ The NAIC model restricts the writing of financial guarantee insurance to monoline companies and establishes new standards for contingency and loss reserves, and aggregate and single risk limits.

39/ The Commission requests that commentators address, among other things, how the evaluation of the risk assumed and the pricing of the product is similar to or different from traditional insurance products. Some trade articles, for example, have stated that financial guarantee insurance is priced for "no loss." See, e.g., Brenner, supra note 6, at 17.

product or the companies which offer it, 40/ and whether financial guarantees are within the protection of state security funds. The Commission seeks comment not only on the nature of the state regulatory framework that governs financial guarantee insurance, but also on the adequacy of that regulatory framework. Does it provide sufficient safeguards to investors to dispense with the protections of the Securities Act?

Commentators also are requested to provide information on the different kinds of financial guarantee insurance currently being offered by insurance companies. 41/ What are the purposes for which the guarantees are used, and what are the underwriting standards for the products? What are the features of such contracts and how do they operate? Are such policies non-cancellable? Are the premiums fixed at the time of purchase? Do investors in a debt obligation have any interest in payments made by an insurer in the event of nonpayment by the issuer of the debt obligation? Does the nature of that interest vary according to the type of insurance? How promptly must payment on the policy be made?

The Commission also seeks information on the size of the financial guarantee insurance market as it currently exists, as well as trends in that market. Commentators are requested to provide statistical information on the specific kinds and dollar

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40/ For example, do any states require that such insurance be offered solely through monoline companies?

41/ The Commission requests that commentators submit copies of sample contracts.

volumes of financial guarantees currently being marketed by insurance companies. For example, what is the dollar volume of municipal bond insurance and corporate debt insurance? What are the current trends in this market, and how would an exemption from registration affect the volume of guaranteed securities issued?

The Commission also is interested in the experience of those insurance companies that have issued financial guarantees to date. What percentage of those companies that offer such insurance are experiencing financial difficulties by virtue of their participation in this business or otherwise? What percentage of failures or withdrawals from the business have occurred, and what was the cause of those failures or withdrawals? Have insurers been unable to fulfill, or sought to void, their commitments?

In considering the circumstances under which debt securities guaranteed by insurance policies should be exempt from registration, commentators should consider whether the guaranteed security, the insurance policy, or both should be subject to the antifraud provisions of the securities laws. Commentators also should consider the conditions, if any, that should form the basis for such an exemption. For example, it has been suggested that an exemption should be limited to guaranteed debt securities rated in the highest category by one or more nationally recognized statistical rating organizations. 42/ How should a "nationally

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42/ *See* S. 1416, 99th Cong., 2d Sess. § 208.

recognized statistical rating organization" be defined for purposes of such an exemption? 43/ How do rating organizations evaluate guaranteed securities, and do such ratings, when coupled with state insurance regulation, provide a reasonable basis for dispensing with registration and disclosure requirements? Should security holders have recourse against a rating organization in the event it makes errors about the quality of a security? If such an exemption were enacted, should rating organizations be subject to some form of regulation?

Should an exemption be conditioned on the availability of public information about the insurer or the issuer of the guaranteed security? Should the insurer be responsible for the accuracy of any offering documents?

Commentators should also consider the types of guarantees that should form the bases for an exemption from registration. For example, should securities backed by GICs that are within Section 3(a)(8) be exempted? Should securities that are insured only so long as they are held by a particular party be exempted?

Further, commentators are asked to address whether the Commission should have authority to exempt guaranteed securities

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43/ At the present time, the following organizations are considered "nationally recognized statistical rating organizations" for purposes of Rule 15c3-1(c)(2)(vi)(F) under the Securities Exchange Act of 1934: Duff and Phelps, Inc.; Fitch Investors Services, Inc.; Moody's Investors Services, Inc.; McCarthy, Crisanti & Maffei; and Standard & Poors Corporation. See Investment Company Act Release No. 15314 (Sept. 17, 1986) at n.32.

by rule or by some other method. What limitations, if any, should be placed on the Commission's authority to exempt guaranteed securities?

IV. CONCLUSION

In conducting the study of the financial guarantee market mandated by Congress, the Commission is seeking comment on a number of specific matters concerning financial guarantees. In addition to those matters, the Commission requests that commentators address generally whether the merits of a security should be relevant to granting an exemption from the Securities Act's registration requirements. The arguments for exempting securities backed by financial guarantees is based, in large part, on the perceived safety and low credit risk of such securities. Given the policies of full and fair disclosure embodied in the Securities Act, should the merits of a security be relevant to a determination to exempt the security?

The Commission requests commentators to address the issues raised in this release and any other issues they believe are relevant to the study.

LIST OF SUBJECTS IN 17 C.F.R. PART 230

Reporting and recordkeeping requirements,
Securities

By the Commission.

Jonathan G. Katz
Secretary.

Dated: February 6, 1987