

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240, 242, and 249

[Release No. 34-64352; File No. S7-15-11]

RIN 3235-AL14

Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: This is one of several proposed rules that the Securities and Exchange Commission (the “Commission”) will be considering relating to the use of credit ratings in Commission rules and forms. Section 939A of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) requires the Commission to remove any references to credit ratings from its regulations and to substitute such standard of creditworthiness as the Commission determines to be appropriate. In this release, the Commission is proposing to amend certain rules and one form under the Securities Exchange Act of 1934 (the “Exchange Act”) applicable to broker-dealer financial responsibility, distributions of securities, and confirmations of transactions. The Commission also is requesting comment on potential standards of creditworthiness for purposes of Exchange Act Sections 3(a)(41) and 3(a)(53), which define the terms “mortgage related security” and “small business related security,” respectively, as the Commission considers how to implement Section 939(e) of the Dodd-Frank Act.

DATES: Comments should be received on or before July 5, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-15-11 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission,

100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number S7-15-11. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site (<http://www.sec.gov/rules/concept.shtml>). Comments are also available for Web site viewing and printing in the Commission’s Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT:

Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Deputy Associate Director, at (202) 551-5521; Randall W. Roy, Assistant Director, at (202) 551-5522; Mark M. Attar, Branch Chief, at (202) 551-5889; Carrie A. O’Brien, Special Counsel, at (202) 551-5640; and Leigh E. Bothe, Attorney, at (202) 551-5511, Office of Financial Responsibility (Net Capital, Customer Protection, and Books and Records Requirements, and Section 939(e) of the Dodd-Frank Act); Josephine J. Tao, Assistant Director, Elizabeth A. Sandoe, Senior Special Counsel, David P. Bloom, Branch Chief, or Bradley Gude, Special Counsel, Office of Trading Practices and Processing at (202) 551-5720 (Regulation M); and Joseph M. Furey, Co-Acting Chief Counsel, and Ignacio Sandoval, Special Counsel, Office of Chief Counsel at (202) 551-5550 (Confirmation of Transactions), Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION: On July 21, 2010, the President signed the Dodd-Frank Act into law. The Commission is requesting public comment on proposed amendments to Exchange Act Rules 15c3-1, 15c3-3, 17a-4, 101 and 102 of Regulation M, and 10b-10, and one Exchange Act form—Form X-17A-5, Part IIB—to remove references to credit ratings and, in certain cases, substitute alternative standards of creditworthiness as required by Section 939A of the Dodd-Frank Act.¹ The Commission is also requesting public comment on potential standards of

creditworthiness for purposes of Exchange Act Sections 3(a)(41) and 3(a)(53), which define the terms “mortgage related security” and “small business related security,” respectively, as the Commission considers how to implement Section 939(e) of the Dodd-Frank Act.

I. Background

A. Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Act was enacted to, among other things, promote the financial stability of the United States by improving accountability and transparency in the financial system.² Title IX, Subtitle C, of the Dodd-Frank Act³ includes provisions regarding statutory and regulatory references to credit ratings in Exchange Act rules, as well as in the Exchange Act itself.⁴

Specifically, in Section 939A of the Dodd-Frank Act, Congress requires that the Commission “review any regulation issued by [the Commission] that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings.”⁵ Once the Commission has completed that review, the statute provides that the Commission “remove any reference to or requirement of reliance on credit ratings, and to substitute in such regulations such standard of creditworthiness” as the Commission determines to be appropriate.⁶

As is discussed in detail below, there are five Exchange Act rules—Rule 15c3-1, Rule 15c3-3, Rules 101 and 102 of Regulation M, and Rule 10b-10—administered by the Commission and one Exchange Act form—Form X-17A-5, Part IIB—that the Commission is proposing to amend in this release as directed by Section 939A of the Dodd-Frank Act. The Commission is also proposing corresponding changes to Exchange Act Rule 17a-4, relating to broker-dealer recordkeeping.

² See Public Law 111-203, 124 Stat. 1376 (2010); Public Law 111-203, Preamble.

³ Public Law 111-203, 124 Stat. 1376 (2010).

⁴ These provisions are designed “[t]o reduce the reliance on ratings.” See *Joint Explanatory Statement of the Committee of Conference*, Conference Committee Report No. 111-517, to accompany H.R. 4173, 864-879, 870 (Jun. 29, 2010).

⁵ Public Law 111-203 § 939A(a)(1)-(2).

⁶ See Public Law 111-203 § 939A(b). The Commission has recently proposed amendments to its rules in other contexts under the federal securities laws to remove references to credit ratings. See *References to Credit Ratings in Certain Investment Company Act Rules and Forms*, Securities Act of 1933 (“Securities Act”) Release No. 9193 (Mar. 3, 2011), 76 FR 12896 (Mar. 9, 2011) and *Security Ratings*, Exchange Act Release No. 63874 (Feb. 9, 2011), 76 FR 8946 (Feb. 16, 2011).

¹ See Public Law 111-203 § 939A.

Further, in Section 939(e) of the Dodd-Frank Act,⁷ Congress deleted Exchange Act references to credit ratings in two sections: (1) In Exchange Act Section 3(a)(41),⁸ which defines the term “mortgage related security,” and (2) in Exchange Act Section 3(a)(53),⁹ which defines the term “small business related security.” In place of the credit rating references, Congress added language stating that a mortgage related security and a small business related security will need to satisfy “standards of credit-worthiness as established by the Commission.”¹⁰ This replacement language becomes effective on July 21, 2012 (*i.e.*, two years after the date the Dodd-Frank Act was signed into law).

As is discussed in detail below, the Commission also is requesting comment on potential standards of creditworthiness for purposes of Exchange Act Sections 3(a)(41) and 3(a)(53), as the Commission considers how to implement Section 939(e) of the Dodd-Frank Act.

B. Previous Commission Action

In 1975, the Commission adopted the term “nationally recognized statistical rating organization” (“NRSRO”) as part of the Commission’s amendments to its broker-dealer net capital rule, Exchange Act Rule 15c3-1 (the “Net Capital Rule”).¹¹ Although the Commission originated the use of the term NRSRO for a narrow purpose in its own regulations, ratings by NRSROs today are widely used as benchmarks in federal and state legislation, rules by financial and other regulators, foreign regulatory schemes, and private financial contracts. The Commission’s initial regulatory use of the term NRSRO was intended solely to provide a method for determining capital charges on different grades of debt securities under the Net Capital Rule. The Commission’s reference to NRSROs for purposes of certain rules increased over time.

Subsequent to the adoption of many of the Commission’s requirements using the NRSRO concept, the Commission—in 2006—obtained registration and oversight authority with respect to credit rating agencies that register to be treated as NRSROs.¹² In response, the

Commission adopted rules to implement a registration and oversight program for NRSROs in June 2007.¹³

The Commission notes that this is not the first time that the Commission has proposed to remove references to credit ratings in Commission rules. The Commission issued a concept release in 1994 on the general idea of removing references to NRSROs in its rules.¹⁴ In 2003, the Commission again sought comment on whether it should eliminate the NRSRO designation from Commission rules, and, if so, what alternatives could be adopted to meet the Commission’s regulatory objectives.¹⁵ Most recently, in July 2008, the Commission made specific proposals to remove rule references to

(2006). Among other things, the Rating Agency Act of 2006 defined the terms “credit rating agency” and “nationally recognized statistical rating organization” in Exchange Act Sections 3(a)(61) and 3(a)(62), respectively. See Public Law 109-291 § 3. Under Section 3(a)(61), the term “credit rating agency” means any person: (A) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; (B) employing either a quantitative or qualitative model, or both, to determine credit ratings; and (C) receiving fees from either issuers, investors, or other market participants, or a combination thereof. 15 U.S.C. 78c(a)(61). Under Section 3(a)(62), the term “nationally recognized statistical rating organization” means a credit rating agency that: (A) issues credit ratings certified by qualified institutional buyers, in accordance with section 15E(a)(1)(B)(ix) of the Exchange Act, with respect to (i) financial institutions, brokers, or dealers; (ii) insurance companies; (iii) corporate issuers; (iv) issuers of asset-backed securities (as that term is defined in section 1101(c) of part 229 of title 17, Code of Federal Regulations, as in effect on the date of enactment of this paragraph); (v) issuers of government securities, municipal securities, or securities issued by a foreign government; or (vi) a combination of one or more categories of obligors described in any clauses (i) through (v); and (B) is registered under Exchange Act Section 15E.

¹³ See *Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 55857 (Jun. 5, 2007), 72 FR 33564 (Jun. 18, 2007). The implementing rules were Form NRSRO, Rule 17g-1, Rule 17g-2, Rule 17g-3, Rule 17g-4, Rule 17g-5, and Rule 17g-6. The Commission has twice adopted amendments to some of these rules. See *Amendments to Rules for Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 59342 (Feb. 2, 2009), 74 FR 6456 (Feb. 9, 2009); and *Amendments to Rules for Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 61050 (Nov. 23, 2009), 74 FR 63832 (Dec. 4, 2009). The Commission also recently added a new NRSRO rule. See *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Securities Act Release No. 9175 (Jan. 20, 2011), 76 FR 4489 (Jan. 26, 2011).

¹⁴ See *Concept Release: Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 34616 (Aug. 31, 1994), 59 FR 46314 (Sep. 7, 1994).

¹⁵ See *Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws*, Exchange Act Release No. 47972 (Jun. 4, 2003), 68 FR 35258 (Jun. 12, 2003).

ratings by NRSROs.¹⁶ In response, the Commission received many comments that raised serious concerns about removing the references.¹⁷ Commenters argued that removing NRSRO references in the context of the Net Capital Rule would decrease the transparency of broker-dealers’ net capital computations and negatively affect market confidence in the financial strength of broker-dealers.¹⁸ In addition, commenters contended that the proposed amendments would place an undue burden on broker-dealers to justify the propriety of internal methods for determining haircuts and on Commission examiners who might be required to review those methods.¹⁹

In October 2009, the Commission adopted several of the proposed reference removals and re-opened for comment the remaining proposals.²⁰ As noted above, in each of these concept releases and rule proposals, commenters generally did not support the removal of references to NRSRO ratings from Commission rules and provided few possible regulatory alternatives. The Commission recognizes the concerns raised by commenters that replacing credit ratings—which provide an objective benchmark—with more subjective approaches could increase costs to broker-dealers and the

¹⁶ See *Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 58070 (Jul. 1, 2008), 73 FR 40088 (Jul. 11, 2008).

¹⁷ See *Comments on References to Ratings of NRSROs*, available on the Commission’s Internet Web site at <http://www.sec.gov/comments/s7-17-08/s71708.shtml>.

¹⁸ See, e.g., Letter from Jeffrey T. Brown, Senior Vice President, Charles Schwab & Co., Inc. to Florence E. Harmon, Acting Secretary, Commission, dated Sep. 5, 2008, stating, “we are concerned that the Commission’s proposed amendments to remove references to NRSRO ratings from [R]ule 15c3-1 (the Net Capital Rule) * * * may be destabilizing and inject risk and uncertainty into the operations of broker-dealers, investment advisers and money market mutual funds. We urge the Commission to retain the references to NRSRO ratings as a minimum floor of credit quality.”

¹⁹ See, e.g., Deborah A. Cunningham and Boyce I. Greer, SIFMA Credit Rating Agency Task Force Co-Chair to Elizabeth M. Murphy, Secretary, Commission, dated Dec. 9, 2009.

²⁰ See *References to Ratings of Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 60789 (Oct. 5, 2009), 74 FR 52358 (Oct. 9, 2009) (adopting release). In the adopting release, the Commission amended Exchange Act Rule 3a1-1 (17 CFR 240.3a1-1), Exchange Act Rules 300, 301(b)(5) and 301(b)(6) of Regulation ATS (17 CFR 242.300, 242.301(b)(5) and 242.301(b)(6)), Form ATS-R (17 CFR 249.638) and Form PILOT (17 CFR 249.821). The Commission also adopted amendments to Rules 5b-3 and 10f-3 under the Investment Company Act of 1940 (17 CFR 270.5b-3 and 17 CFR 270.10f-3). See *References to Ratings of Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 60790 (Oct. 5, 2009), 74 FR 52374 (Oct. 9, 2009) (re-opening comment for Net Capital Rule purposes and various Exchange Act rules).

⁷ Public Law 111-203 § 939(e).

⁸ 15 U.S.C. 78c(a)(41).

⁹ 15 U.S.C. 78c(a)(53).

¹⁰ Public Law 111-203 § 939(e).

¹¹ See *Adoption of Uniform Net Capital Rule and an Alternative Net Capital Requirement for Certain Brokers and Dealers*, Exchange Act Release No. 11497 (Jun. 26, 1975), 40 FR 29795 (Jul. 16, 1975) and 17 CFR 240.15c3-1.

¹² See Credit Rating Agency Reform Act of 2006 (“Rating Agency Act of 2006”); Public Law 109-291

Commission. For example, broker-dealers would be required to allocate resources toward developing and maintaining compliance processes, and the Commission would likewise be required to allocate resources toward examining for compliance. The Commission also recognizes that an alternative approach, if too rigid, could narrow the types of financial instruments that qualify for benefits under existing rules and, if too flexible, could broaden the types of financial instruments that qualify for benefits under existing rules. The Commission, in proposing alternatives to credit ratings, is seeking generally to neither narrow nor broaden the scope of financial instruments that would qualify for the benefits conferred in the existing rules while, at the same time, fulfilling the statutory mandate in Section 939A of the Dodd-Frank Act.²¹ In this regard, the Commission seeks comment below on whether the proposed alternatives achieve this goal and whether more effective alternatives exist.

II. Commission Proposals

A. Proposed Amendments to Exchange Act Rule 15c3-1 and the Appendices to the Rule

1. Amendments to Rule 15c3-1

As noted above, the Commission first developed the NRSRO concept for use in the Net Capital Rule. The Net Capital Rule prescribes minimum regulatory capital requirements for broker-dealers.²² A “net liquid assets test” is the fundamental requirement of the Net Capital Rule. This test is designed to provide that a registered broker-dealer maintain at all times more than one dollar of highly liquid assets for each dollar of liabilities (*e.g.*, money owed to customers and counterparties), excluding liabilities that are subordinated to all other creditors by contractual agreement. Consequently, if the broker-dealer experiences financial difficulty, it should be in a position to meet all obligations to customers and counterparties and generate resources to wind-down its operations in an orderly manner without the need of a formal proceeding. The Net Capital Rule operates by requiring a broker-dealer to perform two calculations: (1) A computation of required minimum net capital; and (2) a computation of actual net capital. A broker-dealer must ensure that its actual net capital exceeds its minimum net capital requirement at all times.

To calculate its actual net capital, a broker-dealer first computes its net worth in accordance with generally accepted accounting principles and then adds to this amount certain subordinated liabilities. From that figure, the broker-dealer subtracts assets not readily convertible into cash, such as intangible assets, fixed assets, and most unsecured receivables. The broker-dealer then subtracts prescribed percentages of the market value of securities owned by the broker-dealer (otherwise known as “haircuts”) to discount for potential market movements. A primary purpose of these haircuts is to provide a margin of safety against losses that might be incurred by the broker-dealer as a result of market fluctuations in the prices of, or lack of liquidity in, its proprietary positions. The resulting figure is the broker-dealer’s net capital.

The Net Capital Rule currently applies a lower haircut to certain types of securities held by a broker-dealer if the securities are rated in higher rating categories by at least two NRSROs, since those securities typically are more liquid and less volatile in price than securities that are rated in the lower categories or are unrated. Currently, to receive the benefit of a reduced haircut on commercial paper, the commercial paper must be rated in one of the three highest rating categories by at least two NRSROs.²³ To receive the benefit of a reduced haircut on a nonconvertible debt security and preferred stock, the security must be rated in one of the four highest rating categories by at least two NRSROs.²⁴

In conformance with the Dodd-Frank Act, the Commission is proposing to remove from the Net Capital Rule all references to credit ratings and substitute an alternative standard of creditworthiness. Specifically, in place of the current Net Capital Rule references to credit ratings, the Commission is proposing that a broker-dealer take a 15% haircut on its proprietary positions in commercial paper, nonconvertible debt, and preferred stock unless the broker-dealer has a process for determining creditworthiness that satisfies the criteria described below. However, commercial paper, nonconvertible debt, and preferred stock without a ready market would remain subject to a 100% haircut.²⁵ The 15% haircut is derived

from the catchall haircut amount that applies to a security not specifically identified in the Net Capital Rule as having an asset-class specific haircut, provided the security is otherwise deemed to have a ready market.²⁶ It is also the haircut applicable to most equity securities.²⁷

If a broker-dealer establishes, maintains, and enforces written policies and procedures for determining creditworthiness under the proposed amendments, the broker-dealer would be permitted to apply the lesser haircut requirement currently specified in the Net Capital Rule for commercial paper (*i.e.*, between zero and ½ of 1%), nonconvertible debt (*i.e.*, between 2% and 9%), and preferred stock (*i.e.*, 10%) when the creditworthiness standard is satisfied. Under this proposal, in order to use these lower haircut percentages for commercial paper, nonconvertible debt, and preferred stock, a broker-dealer would be required to establish, maintain, and enforce written policies and procedures designed to assess the credit and liquidity risks applicable to a security, and based on this process, would have to determine that the investment has only a “minimal amount of credit risk.”

Under the proposed amendments, a broker-dealer, when assessing credit risk, could consider the following factors, to the extent appropriate, with respect to each security:²⁸

- Credit spreads (*i.e.*, whether it is possible to demonstrate that a position in commercial paper, nonconvertible debt, and preferred stock is subject to a minimal amount of credit risk based on the spread between the security’s yield and the yield of Treasury or other securities, or based on credit default swap spreads that reference the security);
- Securities-related research (*i.e.*, whether providers of securities-related research believe the issuer of the security will be able to meet its financial commitments, generally, or specifically, with respect to securities held by the broker-dealer);
- Internal or external credit risk assessments (*i.e.*, whether credit assessments developed internally by the broker-dealer or externally by a credit

current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.” 17 CFR 240.15c3-1(c)(11).

²⁶ 17 CFR 240.15c3-1(c)(2)(vi)(j). Securities without a ready market would remain subject to a 100% haircut. 17 CFR 240.15c3-1(c)(2)(vii).

²⁷ 17 CFR 240.15c3-1(c)(2)(vi)(j).

²⁸ This list of factors is not meant to be exhaustive or mutually exclusive.

²³ 17 CFR 240.15c3-1(c)(2)(vi)(E).

²⁴ 17 CFR 240.15c3-1(c)(2)(vi)(F)(1) and (c)(2)(vi)(H).

²⁵ The term “ready market” is defined in the Net Capital Rule as “a market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or

²¹ See Public Law 111-203 § 939.

²² See 17 CFR 240.15c3-1(a).

rating agency, irrespective of its status as an NRSRO, express a view as to the credit risk associated with a particular security);

- Default statistics (*i.e.*, whether providers of credit information relating to securities express a view that specific securities have a probability of default consistent with other securities with a minimal amount of credit risk);

- Inclusion on an index (*i.e.*, whether a security, or issuer of the security, is included as a component of a recognized index of instruments that are subject to a minimal amount of credit risk);

- Priorities and enhancements (*i.e.*, the extent to which a security is covered by credit enhancements, such as overcollateralization and reserve accounts, or has priority under applicable bankruptcy or creditors' rights provisions);

- Price, yield and/or volume (*i.e.*, whether the price and yield of a security or a credit default swap that references the security are consistent with other securities that the broker-dealer has determined are subject to a minimal amount of credit risk and whether the price resulted from active trading); and
- Asset class-specific factors (*e.g.*, in the case of structured finance products, the quality of the underlying assets).

To establish a basis for a haircut of less than 15% for commercial paper, nonconvertible debt, or preferred stock, a broker-dealer would have to establish, maintain, and enforce written policies and procedures for determining the creditworthiness of a security acquired by the firm. The range and type of specific factors considered would vary depending on the particular securities that are reviewed. A broker-dealer that applies a haircut below 15%, as described above, would have a greater burden to support its application of that haircut when a creditworthiness finding under one factor is contradicted by a finding under another factor. Further, any broker-dealer that determines that application of the factors specified above do not support a finding of a minimal amount of credit risk would apply the 15% haircut with respect to the subject security, or, if that security does not have a ready market, a 100% haircut.²⁹

²⁹ A financial instrument that possesses the necessary credit ratings under Rule 15c3-1 is nevertheless subject to the 100% deduction required by the rule if the financial instrument does not have a ready market. For example, commercial paper rated in the third highest credit rating category may not have a ready market and, therefore, would be subject to the 100% deduction. See, *e.g.*, Nandkumar Nayar and Michael S. Rozeff, *Ratings, Commercial Paper, and Equity Returns*, XLIX J. of Finance 1431, 1433, n.5 (1994) (noting

Each broker-dealer would be required to preserve for a period of not less than three years, the first two years in an easily accessible place, the written policies and procedures that the broker-dealer establishes, maintains, and enforces for assessing credit risk for commercial paper, nonconvertible debt, and preferred stock. Broker-dealers would be subject to this requirement in the Commission's broker-dealer record retention rule, Exchange Act Rule 17a-4, which the Commission is proposing to amend in conjunction with this rulemaking.³⁰

A broker-dealer's process for establishing creditworthiness and its written policies and procedures documenting that process would be subject to review in regulatory examinations by the Commission and self-regulatory organizations. A broker-dealer that applies a haircut of less than 15% for commercial paper, nonconvertible debt, and preferred stock without establishing, maintaining, and enforcing written policies and procedures reasonably designed to assess creditworthiness would be subject to disciplinary action for non-compliance with the rule and could be required to recalculate its net capital.

The Commission preliminarily believes that these new standards would enable broker-dealers to make the net capital computations required under the Net Capital Rule reflect the market and credit risk inherent in particular commercial paper, nonconvertible debt, and preferred stock.³¹ The Commission also recognizes that credit ratings may provide useful information to institutional and retail investors as part of the process of making an investment decision. The requirements of the current rule are based on the practice of many NRSROs to have at least eight categories of ratings for debt securities, with the top four ratings commonly referred to in the industry as "investment grade." Although the proposed amendments do not use the term "investment grade," they are meant to capture securities that should

that "issuers with the lowest ratings find that they cannot issue commercial paper in quantity"). The Commission notes that treatment of commercial paper rated in the third highest credit rating as discussed in this release is limited to Rule 15c3-1 only.

³⁰ Specifically, the Commission is proposing to adopt a new paragraph (b)(13) of Rule 17a-4, which would require broker-dealers to preserve the written policies and procedures the broker-dealer establishes, maintains, and enforces to assess creditworthiness of nonconvertible debt, preferred stock, and commercial paper under the Net Capital Rule.

³¹ See *Uniform Net Capital Rule*, Exchange Act Release No. 13635 (Jun. 16, 1977), 42 FR 31778 (Jun. 23, 1977).

generally qualify for that designation, without placing undue reliance on third-party credit ratings.

Currently, the Net Capital Rule distinguishes between those securities that are rated in one of the three highest categories by an NRSRO (*i.e.*, for commercial paper) and those securities that are rated in one of the four highest ratings by an NRSRO (*i.e.*, for nonconvertible debt and preferred stock). The proposed amendments would eliminate the distinction among types of securities. Instead, each of the three classes of securities would be subject to the same requirements under the proposed amendments.

According to data collected by the Commission, of the approximately 5,060 broker-dealers registered with the Commission as of year-end 2009, approximately 480 broker-dealers maintained proprietary positions in debt securities at that time.³² Thus, it appears that only a small percentage of active broker-dealers registered with the Commission would be impacted by the proposed amendments. The Commission preliminarily believes, based on its oversight activities, that many of the broker-dealers with substantial proprietary positions in debt securities already make independent assessments of creditworthiness based on the types of factors identified in the proposed amendments.

As noted above, the Commission does not intend through the proposed amendments to narrow or broaden the range of securities that generally qualify for reduced haircuts under the Net Capital Rule as currently written. The Commission recognizes that broker-dealers, when purchasing for their proprietary accounts, provide a substantial source of capital for issuers of commercial paper, nonconvertible debt, and preferred stock. Accordingly, any significant change in practice by broker-dealers, whether because of potential compliance costs, difficulties in applying the proposed criteria or minimal credit risk standard, or other factors, that results in a change in the

³² This number was obtained by reviewing broker-dealer Financial and Operational Combined Single (or "FOCUS") Reports for 2009 year-end and then calculating how many firms reported holding proprietary debt positions. For FOCUS Part II filers, the balances examined were "Bankers Acceptances" and "Corporate Debt." For FOCUS CSE filers, the balances examined were: "Money Market Instruments," "Private Label Mortgage Backed Securities," "Other Asset Backed Securities," and "Corporate Debt." For Part IIA filers, the balance examined was "Debt Securities." Broker-dealers that hold preferred stock also may hold positions in debt securities. However, because preferred stock is not a separate line item on the FOCUS Report, broker-dealers that hold only preferred stock and not other debt securities are not included in this estimate.

general allocation of such securities in proprietary accounts could have unintended consequences. Accordingly, the Commission is interested in receiving comment on the potential impact of the proposed amendments on the capital markets generally, and on capital raising efforts by issuers of the affected types of securities specifically, and on how any potential effect could be mitigated or eliminated.

The Commission requests comment on all aspects of these proposed amendments. In addition, the Commission requests comment on the following specific questions:

- Do broker-dealers that would be subject to the proposed amendments either already have processes in place for determining creditworthiness of commercial paper, nonconvertible debt, and preferred stock or have the financial sophistication and the resources necessary to adopt such processes without undue effort or expense? Are there particular types of broker-dealers that would not be capable of meeting this new standard without undue hardship? In what ways and to what extent, if any, would establishing and implementing procedures for determining creditworthiness in lieu of using a credit rating disproportionately impact medium-sized and smaller broker-dealers? Commenters who believe that medium-sized and smaller broker-dealers would be disproportionately affected by these amendments, should describe the firms that would be adversely impacted, as well as provide suggestions as to how the proposal could be amended to accommodate them.

- With respect to the factors a broker-dealer could consider, would the use of these factors in lieu of credit ratings reduce undue reliance on a third party's assessment of credit risk? To what extent, if any, is there a risk that undue reliance will shift from relying on a credit rating to relying on some other third party assessment of creditworthiness?

- What is the potential impact of moving from an objective standard to a more flexible standard? Is there the potential that a broker-dealer's evaluations of creditworthiness may be second-guessed? If so, how might the prospect of being second-guessed impact a broker-dealer's evaluation of minimal credit risk and the appropriate haircuts to take for purposes of the broker-dealer's net capital calculation?

- If broker-dealers establish and implement procedures for determining creditworthiness, some broker-dealers may determine that a security qualifies for a reduced haircut when it would not

have qualified for a reduced haircut under the current NRSRO standard. Alternatively, some broker-dealers may determine that a security does not qualify for a reduced haircut when the security would have qualified for a reduced haircut under the current standard. Describe the potential impact on capitalization and the efficient allocation of capital under these two scenarios and the likelihood of each occurring. In addition, with respect to the first scenario, describe the potential impact on the objective of Rule 15c3-1, which, among other things, is to protect investors by enabling a broker-dealer, if the firm experiences financial difficulty, to be in a position to meet all obligations to customers and counterparties and generate resources to wind-down its operations in an orderly manner without the need of a formal proceeding.

- What are the risks of using internal processes to make credit determinations and how could these risks be addressed? For example, would broker-dealers be likely to adopt procedures that minimize the credit risk associated with a particular security in order to minimize capital charges? How could this risk be addressed?

- Are there other factors a broker-dealer should use when determining creditworthiness? Should the Commission mandate that broker-dealers consider each factor in this release when assessing a security's credit risk? Should the list of factors be included in the text of Rule 15c3-1?

- Should the Commission place conditions on the ability of a broker-dealer to outsource factors related to the determination of creditworthiness to a third party? If the determination of factors related to creditworthiness is outsourced, how can the Commission determine that the outsourced determination meets the proposed standard?

- How often should a broker-dealer be required to update its assessment of a specific security to ensure the broker-dealer's determination of creditworthiness remains current? Should the rule contain a requirement that the assessment be updated after a specific period of time? Should the Commission limit the ability of a broker-dealer to outsource the monitoring of its determination of creditworthiness?

- Should the Commission require that the persons responsible for developing a broker-dealer's internal processes and applying them to possible positions in individual securities for purposes of the Net Capital Rule be separate from employees who make proprietary

investment decisions for the broker-dealer?

- What would be the appropriate level of regulatory oversight of a broker-dealer's credit determination processes? Should the Commission describe in more detail how examiners will examine these processes? How should a broker-dealer be able to demonstrate to regulators the adequacy of the processes that it adopts and that it is following them?

- Should the Commission require the securities industry self-regulatory organizations to set appropriate standards for broker-dealers to use in evaluating creditworthiness and evaluating individual positions in commercial paper, nonconvertible debt, and preferred stock for net capital purposes?

- Should the Commission require broker-dealers to create and maintain records of creditworthiness determinations? If so, what records should be required to be maintained and how should they be described in a rule? Are there standard records that are used when making creditworthiness determinations that the Commission could require broker-dealers to keep? Are there other measures the Commission could consider to reduce the risk that broker-dealers will adopt inadequate processes or fail to adhere to them?

- Rather than referencing a list of factors that broker-dealers could consider, should the rule reference a single or limited set of factors (e.g., credit spreads)? Could a simpler approach adequately capture the risks of holding the full range of securities covered by the rule?

- Are there alternate and more reliable means of establishing creditworthiness for purposes of the Net Capital Rule? Please include detailed descriptions.

- Should the Commission define "minimal amount of credit risk"? Commenters who believe the Commission should define this term should include a detailed description of what should be included in the definition.

2. Proposed Amendments to Appendix A to Rule 15c3-1

Appendix A to Rule 15c3-1 allows broker-dealers to employ theoretical option pricing models in determining net capital requirements for listed options and related positions.³³ Broker-dealers may also elect a strategy-based methodology.³⁴ The purpose of

³³ 17 CFR 240.15c3-1a.

³⁴ *Id.*

Appendix A is to simplify the net capital treatment of options in order to reflect the risk inherent in options and related positions.³⁵

Under Appendix A, broker-dealers' proprietary positions in "major market foreign currency" options receive more favorable treatment than options for all other currencies when using theoretical option pricing models to compute net capital deductions. The term "major market foreign currency" is currently defined to mean "the currency of a sovereign nation whose short-term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and for which there is a substantial inter-bank forward currency market."³⁶

With respect to the definition of the term "major market foreign currency," the Commission proposes to remove from that definition the phrase "whose short-term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations." The change would modify the definition of that term to include foreign currencies only "for which there is a substantial inter-bank forward currency market." The Commission also is proposing to eliminate the specific reference in the rule to the European Currency Unit (ECU), which is identified by the rule as the only major market foreign currency under Appendix A.³⁷ However, because of the establishment of the euro as the official currency of the euro-zone, a specific reference to the ECU is no longer needed. The Commission preliminarily believes that specific reference to the euro also is not necessary, as it is a foreign currency with a substantial inter-bank forward currency market.

The Commission requests comment on all aspects of the proposed amendments to Appendix A to the Net Capital Rule. In addition, the Commission requests comment on the following specific questions:

- Is the proposed definition of "major market foreign currency" sufficiently clear to allow broker-dealers to determine which currencies qualify as major market foreign currencies?

- It is not the intention of the Commission to change the currencies that meet the definition of "major market foreign currency" under this rule. Does the new definition of "major market foreign currency" achieve this

goal? Does the Commission need to keep an example of a "major market foreign currency" in the definition?

- How should the Commission distinguish between major market foreign currencies and all other currencies? Should the rule provide that broker-dealers can apply for a Commission determination (e.g., in the form of an Order or other Commission action) that a currency be considered a major market foreign currency under Appendix A to Rule 15c3-1? Should a list be created and published on the Commission's Web site? Should the Commission rely on other lists, such as the list of member countries of the Organization for Economic Co-Operation and Development?³⁸ Should the determination be made by one of the self-regulatory organizations?

- Should the Commission replace the language in Appendix A to Rule 15c3-1 with a new standard? If so, what should that standard be? Should the Commission use the same standard of creditworthiness and require the same type of process that it has proposed above for Rule 15c3-1?

3. Proposed Amendments to Appendix E to Rule 15c3-1

Pursuant to Appendix E to Rule 15c3-1, a broker-dealer may apply to the Commission for authorization to use an alternative method for computing capital (*i.e.*, the alternative net capital, or "ANC," computation).³⁹ Specifically, broker-dealers with internal risk management practices that utilize certain mathematical modeling methods to manage their own business risk, including value-at-risk ("VaR") models and scenario analysis, may apply to use these methods to compute net capital requirements for market risk and derivatives-related credit risk.

Under Appendix E, broker-dealers subject to the ANC computation are required to deduct from their net capital credit risk charges that take counterparty risk into consideration. This counterparty risk determination is currently based on either NRSRO ratings or a dealer's internal counterparty credit rating. To comply with Section 939A of the Dodd-Frank Act, the Commission is proposing to remove paragraphs (c)(4)(vi)(A) through (c)(4)(vi)(D) of Appendix E, which base credit risk charges for counterparty risk on NRSRO

ratings, and in place of these ratings, require a broker-dealer using the ANC computation to apply a credit risk weight of either 20%, 50%, or 150% with respect to an exposure to a given counterparty based on the internal credit rating the broker-dealer determines for the counterparty.

As a result, a broker-dealer that applies to use the approach set forth in Appendix E to determine counterparty risk would be required, as part of its initial application or in an amendment to the application, to request Commission approval to determine credit risk weights of either 20%, 50%, or 150% based on internal calculations and credit ratings. The Commission notes that all of the firms approved to use models to calculate market and credit risk charges under Appendix E to Rule 15c3-1 have been approved to determine credit ratings using internal ratings rather than ratings issued by NRSROs.⁴⁰ Under the proposal, firms that are already approved to use the ANC computation in Appendix E would not need to seek new approval from the Commission. Other broker-dealers applying for ANC computation in Appendix E would be required to seek approval of their methodology for determining internal ratings. A broker-dealer that is applying to use Appendix E and intends to use internal ratings to determine the applicable credit risk weights should so state in its application to the Commission.

As stated above, all of the broker-dealers approved to use Appendix E to Rule 15c3-1 have already developed models approved for use in performing the ANC computation, as well as internal risk management control systems. As such, each firm already employs an internal credit rating method (*i.e.*, a non-NRSRO credit rating method) that would, under the proposed amendments, become the only option for determining the applicable credit risk weight.

The Commission generally requests comment on all aspects of the proposed amendments to Appendix E to Rule 15c3-1. In addition, the Commission requests comment on the following specific questions:

- Should the Commission replace provisions in Appendix E to Rule 15c3-1 with a new standard? If so, what should that standard be? For example, should the Commission use the same standard of creditworthiness that it has proposed above for commercial paper,

⁴⁰ Currently six broker-dealers are approved to use the ANC computation in Appendix E to Rule 15c3-1.

³⁸ See http://www.oecd.org/pages/0,3417,en_36734052_36761800_1_1_1_1_1,00.html.

³⁹ As a condition of approval, applicants must maintain an "early warning" level of at least \$5 billion in tentative net capital, minimum levels of at least \$1 billion in tentative net capital, and \$500 million in net capital. See 17 CFR 240.15c3-1(a)(7) and (c)(15).

³⁵ See *Net Capital Rule*, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

³⁶ 17 CFR 240.15c3-1a(b)(1)(i)(C).

³⁷ *Id.*

nonconvertible debt, and preferred stock?

- Should the Commission continue to use credit risk weights of 20%, 50%, or 150%? If not, what risk weights should the Commission require be applied?

- Should broker-dealers that are already approved to use Appendix E be required to seek a new determination by the Commission of the credit risk weights assigned to their internal ratings scale?

4. Proposed Amendments to Appendix F to Rule 15c3-1 and the General Instructions to Form X-17A-5, Part IIB

Appendix F to the Net Capital Rule sets forth a program for OTC derivatives dealers that allow them to use an alternative approach to computing net capital deductions, subject to certain conditions.⁴¹ Under Appendix F, OTC derivatives dealers with strong internal risk management practices may utilize the mathematical modeling methods used to manage their own business risk, including VaR models and scenario analysis, to compute deductions from net capital for market and credit risks arising from OTC derivatives transactions.⁴²

Under Appendix F to the Net Capital Rule, OTC derivatives dealers are required to deduct from their net capital credit risk charges that take counterparty risk into consideration. As part of this deduction, the OTC derivatives dealer must apply a counterparty factor of either 20%, 50%, or 100%.⁴³ In addition, the OTC derivatives dealer must take a concentration charge where the net replacement value in the account of any one counterparty exceeds 25% of the OTC derivatives dealer's tentative net capital.⁴⁴ The counterparty factor (*i.e.*, 20%, 50%, or 100%) to apply currently is based on either NRSRO ratings or the

⁴¹ OTC derivatives dealers are a special class of broker-dealers that are exempt from certain broker-dealer requirements, including membership in a self-regulatory organization (17 CFR 240.15b9-2), regular broker-dealer margin rules (17 CFR 240.36a1-1), and application of the Securities Investor Protection Act of 1970 (17 CFR 240.36a1-2). OTC derivative dealers are subject to special requirements, including limitations on the scope of their securities activities (17 CFR 240.15a-1), specified internal risk management control systems (17 CFR 240.15c3-4), recordkeeping obligations (17 CFR 240.17a-3(a)(10)), and reporting responsibilities (17 CFR 240.17a-12). They are also subject to alternative net capital treatment (17 CFR 240.15c3-1(a)(5)). See 17 CFR 240.15a-1, Preliminary Note.

⁴² The minimum net capital requirements for an OTC derivatives dealer are tentative net capital of at least \$100 million and net capital of at least \$20 million. See 17 CFR 240.15c3-1(a)(5) and (c)(15).

⁴³ 17 CFR 240.15c3-1f(d)(2).

⁴⁴ 17 CFR 240.15c3-1f(d)(3).

firm's internal credit ratings.⁴⁵ The concentration charges also are based on either NRSRO ratings or the firm's internal credit ratings. All of the firms approved to use models to calculate market and credit risk charges under Appendix F to Rule 15c3-1 have been approved to determine credit risk charges using internal credit ratings.⁴⁶ To comply with Section 939A of the Dodd-Frank Act, the Commission is proposing to amend Appendix F to Rule 15c3-1 and to make conforming changes to Form X-17A-5, Part IIB.

Specifically, the Commission is proposing to revise paragraphs (d)(2), (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4) of Appendix F to the Net Capital Rule, which permit the use of NRSRO ratings when determining counterparty risk. As a result of these revisions, an OTC derivatives dealer that applies to use the approach set forth in Appendix F to determine counterparty credit risk charges would be required, as part of its initial application or in an amendment to the application, to request Commission approval to determine credit ratings using internal ratings rather than ratings issued by NRSROs. Under the proposal, firms that are already approved to use internal ratings pursuant to Appendix F would not need to seek new approval from the Commission. An OTC derivatives dealer that is applying to use Appendix F and intends to use internal ratings to determine the applicable credit risk weights should so state in its application to the Commission.

As stated above, all of the approved firms have already developed models to calculate market and credit risk under the alternative net capital calculation methods set forth in Appendix F. As such, each firm already employs a non-NRSRO ratings-based method that would, under the proposed amendments, become the only option for calculating credit risk charges.

Based on these proposed amendments to Appendix F to Rule 15c3-1, the Commission is proposing conforming changes to the General Instructions to Form X-17A-5, Part IIB. This form constitutes the basic financial and operational report required of OTC derivatives dealers to be filed with the Commission. Under the heading "Computation of Net Capital and Required Net Capital" and before the section "Aggregate Securities and OTC Derivatives Positions," the Commission is proposing conforming changes to the section "Credit risk exposure." This

⁴⁵ See 17 CFR 240.15c3-1f(d)(2) and (4).

⁴⁶ Currently four firms are using Appendix F to the Net Capital Rule.

section explains the counterparty charges for OTC derivatives dealers based on the language in Appendix F to Rule 15c3-1. Therefore, the Commission is proposing that all changes made to Appendix F to Rule 15c3-1 also be made to the section "Credit risk exposure" under the heading "Computation of Net Capital and Required Net Capital" in the General Instructions to Form X-17A-5, Part IIB.

The Commission generally requests comment on all aspects of the proposed amendments to Appendix F to Rule 15c3-1 and the conforming changes to the General Instructions to Form X-17A-5, Part IIB. In addition, the Commission requests comment on the following specific questions:

- Should the Commission replace the provisions in Appendix F to Rule 15c3-1 with a new standard? If so, what should that standard be? Should the Commission use the same standard of creditworthiness that it has proposed above for commercial paper, nonconvertible debt, and preferred stock?

- Should the Commission continue to use counterparty factors of 20%, 50%, or 100%? If not, what counterparty factors should the Commission require be applied?

- Should the OTC derivatives dealers that have been approved to use Appendix F be required to submit an amendment to their applications to use internal credit ratings?

5. Proposed Amendment to Appendix G to Rule 15c3-1

The Commission is also proposing a conforming amendment to Appendix G to Rule 15c3-1. Under Appendix G, a broker-dealer that uses the ANC computation can only do so if its ultimate holding company agrees to provide the Commission with additional information about the financial condition of the ultimate holding company and its affiliates. Appendix G applies to an ultimate holding company that has a principal regulator and is intended to ensure that the Commission can obtain certain information designed to help the Commission assess the financial and operational health of the ultimate holding company and its potential impact on the risk exposure of the broker-dealer.⁴⁷

The proposed amendment to Appendix G would delete references in that appendix to the provisions of

⁴⁷ Currently, each broker-dealer that uses the ANC computation has an ultimate holding company that has a principal regulator. As a result of both changes to the Commission's regulatory programs and the Dodd-Frank Act, the Commission is no longer regulating ultimate holding companies.

Appendix E that the Commission is proposing to delete as described above. These references are found in paragraph (a)(3)(i)(F) to Appendix G. Because of the proposed amendments to Appendix E described above, the references to Appendix E in Appendix G would no longer be accurate.

The Commission generally requests comment on all aspects of the proposed amendment to Appendix G to Rule 15c3-1.

B. Proposed Amendment to Exhibit A to Rule 15c3-3

Exchange Act Rule 15c3-3 (the "Customer Protection Rule") protects customer funds and securities held by broker-dealers. In general, the Customer Protection Rule has two parts. The first part requires a broker-dealer to have possession or control of all fully paid and excess margin securities of its customers. In this regard, a broker-dealer must make a daily determination in order to comply with this aspect of the rule.

The second part covers customer funds and requires broker-dealers subject to the rule to make a periodic computation to determine how much money it is holding that is either customer money or money obtained from the use of customer securities ("credits"). From that figure, the broker-dealer subtracts the amount of money which it is owed by customers or by other broker-dealers relating to customer transactions ("debits"). If the credits exceed debits after this "reserve formula" computation, the broker-dealer must deposit the excess in a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (a "Reserve Account"). If the debits exceed credits, no deposit is necessary. Funds deposited in a Reserve Account cannot be withdrawn until the broker-dealer completes another computation that shows that the broker-dealer has on deposit more funds than the reserve formula requires.

The Customer Protection Rule is designed to prevent broker-dealers from using customer money to finance their business, except as related to customer transactions, since customer funds (the credits) can be offset only by customer-related transactions (the debits). As a result, broker-dealers must provide the capital to finance their trades and firm activities and may not use customers' funds for such purposes.

Exhibit A to Rule 15c3-3 contains the formula that a broker-dealer must use to determine its reserve requirement. Under Note G to Exhibit A, a broker-dealer may include required customer margin for transactions in security

futures products as a debit in its reserve formula computation if that margin is required and on deposit at a clearing agency or derivatives clearing organization that:

1. Maintains the highest investment-grade rating from an NRSRO;
2. Maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least \$2 billion, at least \$500 million of which must be in the form of security deposits;
3. Maintains at least \$3 billion in margin deposits; or
4. Obtains an exemption from the Commission.⁴⁸

Requiring a clearing agency or a derivatives clearing organization to meet certain minimum criteria before margin deposits with that entity may be included as a debit in a broker-dealer's customer reserve formula is consistent with the customer protection function of Rule 15c3-3, because margin that is posted for customer positions in security futures products constitutes an unsecured receivable from the clearing agency or organization. Accordingly, this requirement is intended to provide reasonable assurance that customer margin deposits related to security futures products are adequately protected.

The Commission is proposing to remove the first criterion described above (*i.e.*, the highest investment-grade rating from an NRSRO). The Commission notes that the criteria are disjunctive and, therefore, a clearing agency or derivatives clearing organization needs to satisfy only one criterion to permit a broker-dealer to treat customer margin as a reserve formula debit. Consequently, the Commission preliminarily believes that the proposed amendment would not lessen the protections for customer funds and securities. Furthermore, while one potential criterion would be removed, there is only one clearing agency for security futures products (namely, the Options Clearing Corporation) and that clearing agency would continue to qualify under each of the other applicable criteria. Moreover, if a new registered clearing agency or derivatives clearing organization could not meet one of the remaining criteria, a broker-dealer may request an exemption for the clearing agency or organization under the rule.⁴⁹

⁴⁸ 17 CFR 240.15c3-3a, Note G.

⁴⁹ The Commission may, in its sole discretion, grant such an exemption subject to such conditions as are appropriate under the circumstances if the

The Commission preliminarily believes that eliminating the reference to NRSRO ratings in Note G to Exhibit A to Rule 15c3-3 will continue to advance the goals of the Customer Protection Rule by ensuring the long-term financial strength of clearing agencies and derivatives clearing organizations holding customer margin for positions in security futures products.⁵⁰ The Commission preliminarily believes that requiring a registered clearing agency or derivatives clearing organization to comply with one of the three remaining criteria will adequately serve the customer protection purpose of Rule 15c3-3.

The Commission generally requests comment on all aspects of the removal of paragraph (b)(1)(i) of Note G to Rule 15c3-3a. In addition, the Commission requests specific comment on the following questions:

- Should the Commission replace the language in paragraph (b)(1)(i) of Note G with a new standard? If so, what should that standard be? Should the Commission use the same standard of creditworthiness that it has proposed above for commercial paper, nonconvertible debt, and preferred stock?

- What factors should the Commission take into account when considering the potential regulatory compliance costs of removing references to NRSROs from paragraph (b)(1) of Note G? Commenters should include detailed descriptions of any potential costs.

- Do the guidelines offered by current paragraphs (b)(1)(ii)-(iv) of Note G provide sufficient means by which a registered clearing agency or derivatives clearing organization could be judged to meet the requirements of paragraph (b)(1) of Note G? If not, what additional information should be added to meet the requirements of paragraph (b)(1) of Note G?

- Are there clearing agencies or derivatives clearing organizations that would not meet the remaining standards contained in paragraph (b)(1) of Note G?

C. Exceptions for Investment Grade Nonconvertible and Asset-Backed Securities in Rules 101 and 102 of Regulation M

As a prophylactic anti-manipulation set of rules, Regulation M is designed to

Commission determines that such conditional or unconditional exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. See paragraph (b)(iv) of Rule 15c3-3a, Note G.

⁵⁰ See *Rule 15c3-3 Reserve Requirements for Margin Related to Security Futures Products*, Exchange Act Release No. 50295 (Aug. 31, 2004), 69 FR 54182 (Sep. 7, 2004).

preserve the integrity of the securities trading market as an independent pricing mechanism by prohibiting activities that could artificially influence the market for an offered security. Rules 101 and 102 of Regulation M specifically prohibit issuers, selling security holders, distribution participants, and any of their affiliated purchasers, from directly or indirectly bidding for, purchasing, or attempting to induce another person to bid for or purchase a “covered security” until the applicable restricted period has ended.⁵¹

Rules 101(c)(2) and 102(d)(2) currently except “investment grade nonconvertible and asset-backed securities.”⁵² These exceptions apply to nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities that are rated by at least one NRSRO in one of its generic rating categories that signifies investment grade. In accordance with Section 939A(b) of the Dodd-Frank Act, the Commission is proposing to remove the references to credit ratings in Rules 101(c)(2) and 102(d)(2) and replace them with new standards relating to the trading characteristics of covered securities.

1. Background

Historically, the Rule 101(c)(2) and 102(d)(2) exceptions trace back to a no-action position taken by the staff in 1975 regarding Exchange Act Rule 10b-6, the predecessor to Rules 101 and 102.⁵³ The lead underwriter of an offering of debentures had written the staff seeking interpretive guidance because Rule 10b-6 prohibited it from making markets in the debt securities of the same issuer other than the security being distributed, as these other securities could be considered “of the same class and series” under Rule 10b-6(a) as the security being distributed.⁵⁴ The staff, with the Commission’s concurrence, provided no-action relief

⁵¹ “Covered security” is defined as “any security that is the subject of a distribution or any reference security,” and “reference security” is defined as “a security into which a security that is the subject of a distribution (‘subject security’) may be converted, exchanged, or exercised or which, under the terms of the subject security, may in whole or in significant part determine the value of the subject security.” 17 CFR 242.100.

⁵² 17 CFR 242.101(c)(2) and 242.102(d)(2).

⁵³ Letter from Robert C. Lewis, Associate Director, the Division of Market Regulation, the Commission to Donald M. Feuerstein, General Partner and Counsel, Salomon Brothers (Mar. 4, 1975).

⁵⁴ As explained below, the activity for which relief was sought in this letter would be permissible under Rules 101 and 102 today even without the investment grade securities exceptions or no action relief because of a change in the securities covered under Rules 101 and 102 as compared to the securities covered under Rule 10b-6.

permitting dealers participating in a distribution of debt securities of an issuer to bid for or purchase other outstanding debt securities of such issuer, but required that the new issue and outstanding issues be subject to certain investment grade ratings.⁵⁵ In granting relief, the staff emphasized representations from the underwriter that (1) “because the nonconvertible bonds of particular issuers are not considered unique and because of the concept of relative value, it is simply not possible to manipulate the price of a corporate bond that has broad investor interest” and (2) purchasing activities in such securities generally are “unlikely to materially affect the price of [a nonconvertible debt security being offered] because of the availability of large amounts of securities of other issuers which have comparable quality yield [spreads].”⁵⁶

In 1983, the Commission amended the rule to fully except all investment grade nonconvertible debt securities from Rule 10b-6.⁵⁷ At that time, the Commission also added an exception for investment grade nonconvertible preferred securities. In proposing the rule changes, the Commission stated that “it is very difficult, if not impossible, to manipulate the price of investment grade debt. Investment grade debt securities are generally thought to trade in accordance with the concept of relative value, *i.e.*, such securities are to a large degree fungible,⁵⁸ so that

⁵⁵ Letter from Robert C. Lewis, Associate Director, the Division of Market Regulation, the Commission, to Donald M. Feuerstein, General Partner and Counsel, Salomon Brothers (Mar. 4, 1975).

⁵⁶ *Id.*

⁵⁷ *Prohibitions Against Trading by Persons Interested in a Distribution*, Exchange Act Release No. 19565 (Mar. 4, 1983), 48 FR 10628 (Mar. 14, 1983). See also *Prohibitions Against Trading by Persons Interested in a Distribution*, Exchange Act Release No. 18528 (Mar. 3, 1982), 47 FR 11482 (Mar. 16, 1982). The 1975 letter included a number of other requirements that were not codified. Letter from Robert C. Lewis, Associate Director, the Division of Market Regulation, the Commission, to Donald M. Feuerstein, General Partner and Counsel, Salomon Brothers (Mar. 4, 1975).

⁵⁸ With regard to whether investment grade nonconvertible preferred securities are largely fungible with investment grade nonconvertible preferred securities of other issuers, the Commission noted that “[n]onconvertible preferred securities possess some of the attributes of debt securities and, when rated investment grade, generally trade on the basis of their value in relation to comparably-rated offerings of other issuers.” *Prohibitions Against Trading by Persons Interested in a Distribution*, Exchange Act Release No. 19565 (Mar. 4, 1983), 48 FR 10628 (Mar. 14, 1983). The Commission further noted that the exceptions are based on the concept “that investment grade debt and preferred securities are traded on the basis of their yields and financial ratings and therefore are largely fungible.” *Id.* The Commission solicits comment below as to whether this understanding with respect to the fungibility of nonconvertible preferred securities remains accurate.

investors generally evaluate new offerings by looking at comparably rated securities of other issuers.”⁵⁹

When Rules 101 and 102 of Regulation M were adopted, the Commission substituted the concept of “same class and series” in Rule 10b-6 with the concept of “covered securities.” The Commission clarified that as a result of this change, “bids for and purchases of outstanding nonconvertible debt securities are not restricted unless the security being purchased is identical in all of its terms to the security being distributed.”⁶⁰ The effect of this change in application was that “as a practical matter, Rule 101 and Rule 102 will have very limited impact on debt securities, except for the rare situations where selling efforts continue over a period of time.”⁶¹ In contrast, under Rule 10b-6, bids for or purchases of debt securities of the issuer other than those being distributed could be prohibited if they were similar to the distributed securities in coupon interest rate and maturity date.

Investment grade asset-backed securities were also added to the exception with the adoption of Regulation M.⁶² The application of the exception to these securities was based on the premise that asset-backed securities also trade primarily on the basis of yield spread and credit rating and that asset-backed securities investors are concerned with “the structure of the class of securities and the nature of the assets pooled to serve as collateral for those securities.”⁶³

2. 2008 Proposal

In 2008, the Commission proposed to eliminate NRSRO references to address concerns that such references contributed to undue reliance on NRSRO ratings by market participants. Specifically, the Commission proposed to remove references to NRSRO ratings from the determination of whether investment grade nonconvertible debt, investment grade nonconvertible preferred, and investment grade asset-backed securities would be eligible for

⁵⁹ *Prohibitions Against Trading by Persons Interested in a Distribution*, Exchange Act Release No. 18528 (Mar. 3, 1982), 47 FR 11482 (Mar. 16, 1982).

⁶⁰ *Anti-manipulation Rules Concerning Securities Offerings*, Exchange Act Release No. 38067 (Dec. 20, 1996), 62 FR 520 (Jan. 3, 1997). The Commission noted that “Rule 101 does not apply to a security if there is a single basis point difference in coupon rates or a single day’s difference in maturity dates, as compared to the security in distribution.” *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Anti-manipulation Rules Concerning Securities Offerings*, Exchange Act Release No. 38067 (Dec. 20, 1996), 62 FR 520 (Jan. 3, 1997).

the Rule 101(c)(2) and 102(d)(2) exceptions, and instead except nonconvertible debt securities and nonconvertible preferred securities based on the “well-known seasoned issuer” (“WKSI”) concept of Securities Act Rule 405 and except asset-backed securities that are registered on Form S-3 (“2008 Regulation M Proposals”).⁶⁴

Those commenters that addressed the proposed Regulation M changes expressed uniform opposition to the proposed amendments.⁶⁵ Many of these commenters stated their view that the proposal is not necessary to address concerns about investors’ undue reliance on NRSRO ratings.⁶⁶ Commenters also stated that, because the 2008 Regulation M Proposals would have altered the scope of the exceptions for investment grade nonconvertible debt securities, investment grade nonconvertible preferred securities, and asset-backed securities, they would have placed new burdens on issuers and underwriters by imposing the restrictions of Regulation M on currently excepted investment grade securities.⁶⁷ Additionally, commenters expressed the view that certain high yield securities that are currently subject to Regulation M, but are arguably more vulnerable to manipulation than securities currently excepted from Regulation M, would have been excepted from Rules 101 and

102 of Regulation M under the 2008 Regulation M Proposals.⁶⁸ These commenters did not suggest any substitute to the proposed rule changes.⁶⁹

3. 2009 Comment Period Re-Opening

In 2009, the Commission deferred consideration of the 2008 Regulation M Proposals and, in light of the uniform opposition by commenters and continuing concern regarding the undue influence of NRSRO ratings, the Commission reopened the comment period for the 2008 Regulation M Proposals.⁷⁰ The Commission received three additional comment letters.⁷¹ Of these, two reiterated earlier objections,⁷² and the third argued that the 2008 Regulation M Proposals would have adverse effects on foreign sovereign issuers of debt securities.⁷³ Although the Commission invited commenters to suggest alternative proposals, no new alternatives were suggested.

4. Current Proposal

In accordance with Section 939A(b) of the Dodd-Frank Act, and in light of the opposition to the 2008 Regulation M Proposals, the Commission is proposing new standards to replace the reference to NRSRO credit ratings in the Regulation M exceptions. Specifically, the Commission proposes to except nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities from Rules 101 and 102 if they: (1) Are liquid relative to the market for that asset class; (2) trade in relation to general market interest rates and yield spreads; and (3) are relatively fungible with securities of similar characteristics and interest rate yield spreads.

The proposed standards are an attempt to codify the subset of trading

characteristics of investment grade nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that make them less prone to the type of manipulation that Regulation M seeks to prevent. The standards are not intended as measures of or proxies for assessments of credit risk, or to provide substitute criteria for whether or not a security would be considered investment grade.

The application of Rules 101 and 102 of Regulation M to debt securities is very limited, as compared to Rule 10b-6. The Commission is interested in comment as to whether and in what circumstances issuers, selling shareholders, distribution participants, and their affiliated purchasers rely on the current exception for investment grade securities (including with respect to specific activities) and, in particular, whether this exception serves a continuing purpose with regard to nonconvertible debt and asset-backed securities. The Commission further solicits comment as to whether, if the application of Rules 101 and 102 of Regulation M to debt securities is in fact quite limited as a practical matter, the current investment grade exception should be eliminated or, alternatively, whether it should be expanded to except from Rules 101 and 102 all nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities (or some subset thereof).

a. Standards

i. Liquid Relative to the Market for the Asset Class

In order to qualify for the proposed exception, a nonconvertible debt, nonconvertible preferred, or asset-backed security would need to be liquid relative to the market for that asset class. The Commission believes that a high degree of liquidity is an important consideration in determining which securities should be eligible for the proposed exception from Rules 101 and 102. In general, the existence of substantial liquidity is indicative of an established, efficient market with a large number of participants, which is less likely to be subject to the type of manipulation with which Regulation M is concerned. Since this exception would apply primarily to a security for which the distribution continues after the security begins to trade, the Commission preliminarily believes that persons seeking to rely on this exception would be able to adequately identify securities that meet this standard.

⁶⁴ Proposed Rule: *References to Ratings of Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 58070 (Jul. 1, 2008), 73 FR 40088 (Jul. 11, 2008).

⁶⁵ We received five comment letters that specifically addressed the Regulation M proposals and each opposed the proposals. See Letters from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association (“ABA”), to Florence E. Harmon, Acting Secretary, dated Oct. 10, 2008 (“ABA Letter”); Robert Dobilas, CEO and President, Realpoint LLC, to Secretary, dated Sep. 8, 2008; Letter from Jeremy Reifsnnyder and Richard Johns, Co-chairs, American Securitization Forum (“ASF”) Credit Rating Agency Task Force, to Florence E. Harmon, Acting Secretary, dated Sep. 5, 2008 (“ASF Letter”); Deborah A. Cunningham and Boyce I. Greer, Co-chairs, Securities Industry and Financial Markets Association (“SIFMA”) Credit Rating Agency Task Force, to Florence E. Harmon, Acting Secretary, dated Sep. 4, 2008 (“SIFMA Letter 1”); and Mayer Brown LLP to Florence E. Harmon, Acting Secretary, dated Sep. 4, 2008 (“Mayer Brown Letter”). There were comment letters supportive of the Commission’s effort to minimize undue reliance on NRSRO ratings by market participants, however, these commenters did not discuss Regulation M. See, e.g., Letter from Suzanne C. Hutchinson, Executive Vice President, Mortgage Insurance Companies of America, to Florence E. Harmon, Acting Secretary, dated Sep. 5, 2008.

⁶⁶ See, e.g., SIFMA Letter 1 (“Regulation M is primarily directed at the actions of the issuers of securities and the investment banks who underwrite them; in contrast, the investors that the Commission is concerned with are not users of Regulation M”).

⁶⁷ ABA Letter, SIFMA Letter 1.

⁶⁸ *Id.*

⁶⁹ The ABA did, however, suggest that should the Commission insist on using the WKSI standard for investment grade nonconvertible debt and investment grade nonconvertible preferred securities, it do so only as an alternative to the current exceptions at Rules 101(c)(2) and 102(d)(2). ABA Letter. However, the ABA expressed its “strong[] belie[f] that the Commission should retain the current exceptions.” *Id.*

⁷⁰ *References to Ratings of Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 60790 (Oct. 5, 2009); 74 FR 52374 (Oct. 9, 2009).

⁷¹ Letter from Mary Keogh, Managing Director, Regulatory Affairs and Daniel Curry, President, DBRS, Inc., to Elizabeth M. Murphy, Secretary, dated Nov. 13, 2009 (“DBRS Letter”); Letter from Steven G. Tepper, Arnold & Porter LLP, to the Honorable Mary L. Schapiro, Chairman, dated Dec. 8, 2009 (“Arnold & Porter Letter”); and Letter from Sean C. Davy, Managing Director, Corporate Credit Markets Division, SIFMA, to Elizabeth M. Murphy, Secretary, dated Dec. 8, 2009 (“SIFMA Letter 2”).

⁷² DBRS Letter and SIFMA Letter 2.

⁷³ Arnold & Porter Letter.

The Commission seeks comment on the standards that may be indicative of relative liquidity, such as the size of the issuance, the percentage of the average daily trading volume by persons other than the persons seeking to rely on the exception, and the number of market makers in the security being distributed other than those seeking to rely on the exception.⁷⁴ Other factors that could be considered include the overall trading volume of the security, the number of liquidity providers who participate in the market for the security, trading volume in similar securities or other securities from the same issuer, overall liquidity of all outstanding debt issued by the same issuer, how quickly an investor could be expected to be able to sell the security after purchase, and, in the case of asset-backed securities, the liquidity and nature of the underlying assets.⁷⁵

ii. Trade in Relation to General Market Interest Rates and Yield Spreads

A nonconvertible debt security, nonconvertible preferred security, or asset-backed security also would need to trade at prices that are primarily driven by general market interest rates and spreads applicable to a broad range of similar securities. This standard would limit the exception's availability to those securities that trade in relation to changes in broader interest rates (*i.e.*, based on their comparable yield spreads), as opposed to securities that trade in relation to issuer-specific information or credit quality.⁷⁶ This characteristic affords market participants the ability to use general market rates to make their own estimates of the value of such a security and whether such security is trading at prices outside of expected ranges. It would be more difficult for market participants to make such an independent judgment if the security traded in an idiosyncratic fashion based primarily on its specific characteristics, such that the traded price of the security could not readily be compared to similar issues. As noted above,

⁷⁴ See, e.g., Letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, the Commission, to Alan J. Sinsheimer, Sullivan & Cromwell (Jan. 12, 2000).

⁷⁵ This list is merely illustrative and should not be considered a necessary or exhaustive list of the factors that could reasonably be considered in evaluating liquidity.

⁷⁶ This was an important distinction for the Commission when adopting the current exceptions. "Investors are therefore more likely to compare yields of new non-investment grade debt offerings with those of outstanding debt securities of the same issuer." *Prohibitions Against Trading by Persons Interested in a Distribution*, Exchange Act Release No. 18528 (Mar. 3, 1982), 47 FR 11482 (Mar. 16, 1982).

investment grade nonconvertible debt, investment grade nonconvertible preferred, and investment grade asset-backed securities were originally excepted in part because they trade in relation to general market interest rates and yield spreads.

iii. Relatively Fungible With Securities of Similar Characteristics and Interest Rate Yield Spreads

Finally, a nonconvertible debt, nonconvertible preferred, or asset-backed security would need to be relatively fungible (in terms of trading characteristics) with similar securities, *i.e.*, securities with similar interest rate yield spreads, in order to qualify for the proposed exception. This standard, along with the requirement that the security trade in relation to general market interest rates and yield spreads explained above, is an attempt to codify a further trading characteristic of the investment grade securities that are currently excepted from Rules 101 and 102. Together with the standard regarding trading in relation to general market interest rates and yield spreads, the Commission preliminarily believes that the fungibility requirement would limit the proposed exception to those securities that pose little risk of manipulation.

Being "relatively fungible" for these purposes would not require that the security, for example, be deliverable for a purchase order for a different security, but rather that a portfolio manager would be willing to purchase the security in lieu of another security that has similar characteristics (*i.e.*, yield spreads, credit risk, etc.). Securities with these characteristics would be less prone to market squeezes or other forms of manipulation. Note that in order to satisfy this requirement, a security need not be completely fungible for all purposes with another security that has similar characteristics.

The Commission preliminarily believes that persons seeking to rely on the exception would be able to objectively demonstrate these three standards were met.

b. Evaluation of the Security

The proposal would require the person seeking to rely on the exception to make the determination that the security in question is liquid relative to the market for the asset class, trades in relation to general market interest rates and yield spreads, and is relatively fungible with securities of similar characteristics and interest rate yield spreads. The determination must be made utilizing reasonable factors of

evaluation and must be subsequently verified by an independent third party.

Each person seeking to rely on the exception would be required to assess the standards laid out in the proposal with regard to the specific nonconvertible debt, nonconvertible preferred, or asset-backed security being distributed. Persons would be required to exercise reasonable judgment in conducting this analysis. Sole reliance on a third party's determination without any further analysis would not be considered to be based on reasonable judgment. Persons seeking to rely on the exception would need to demonstrate compliance with the requirements of this provision.

c. Third Party Verification

In addition to making a determination that the nonconvertible debt, nonconvertible preferred, or asset-backed security reasonably meets the standards of the proposed exception, a person seeking to rely upon the exception also would be required to obtain a verification of this determination by an independent third party. Each person seeking to rely on the exception would be required to make a reasonable determination of the independence and qualifications of a third party for this purpose, based on the third party's relevant professional background, experience, knowledge, and skills. Counsel to, or other affiliates of, the underwriter or issuer, would not meet the independence requirement.⁷⁷ Persons seeking to rely on the exception may be best positioned in the first instance to evaluate all of the factors that would be relevant to the determination, but they also would have an inherent conflict of interest. The third party verification requirement is intended to provide a reliable check on the reasonableness of that determination.

The Commission intends by this proposal generally to except the same types and amounts of securities that are currently excepted in Rules 101(c)(2) and 102(d)(2) without referencing credit ratings. To that end, the Commission is interested in comments on any added costs or other effects that the requirement of independent third party verification in particular may have in distributions of nonconvertible debt, nonconvertible preferred, and asset-backed securities that would result in making the exception less available than it is today. To the extent that the need to obtain a third party verification increases the costs that a person must

⁷⁷ This is not an exhaustive list of persons who would not be considered to be independent.

incur in order to benefit from the exception for these securities from Rules 101 and 102 of Regulation M, the Commission seeks comment as to what those costs are and whether such costs in at least some cases would result in persons who currently rely on the exception determining not to do so. This in turn may effectively expand the circumstances in which Rules 101 and 102 of Regulation M apply, as compared to the status quo. Thus, an increase in costs resulting from the third party verification that is sufficient to alter the behavior of market participants may reduce the practical benefit of the exception.

The Commission also specifically solicits comment regarding the type of entity that would be considered an acceptable independent third party for purposes of this exception. For example, the Commission seeks comment as to whether to limit the acceptable independent third parties to those who could meet the definition of "qualified independent underwriter" for purposes of the SRO rules,⁷⁸ which could provide a familiar bright line standard. The Commission also seeks comment as to whether to limit the acceptable independent third parties to only entities that are registered with the Commission, which would ensure that the Commission has examination authority over those persons acting as independent third party verifiers. The Commission further seeks comment as to whether the proposal should limit the number of times a person seeking to rely on the exception could rely on the same independent third party.

5. Request for Comment

We solicit comments on all aspects of this proposal. We ask that commenters provide specific reasons and information to support alternative recommendations. Please provide empirical data, when possible, and cite to economic studies, if any, to support alternative approaches.

⁷⁸ See Financial Industry Regulatory Authority ("FINRA") Rule 5121(f)(12). This rule generally requires that a qualified independent underwriter be a FINRA member, have no conflict of interest in the offering, not be an affiliate of a FINRA member that does have a conflict of interest, not beneficially own more than 5% of the class of securities that would give rise to a conflict of interest, have agreed in writing to be a qualified independent underwriter and undertake the legal responsibilities and liabilities of an underwriter under the Securities Act, have specific offering experience, and not have any supervisory associated persons who are responsible for organizing, structuring, or performing due diligence with respect to corporate public offerings of securities that have certain disciplinary histories.

- How often are these exceptions utilized where no other exception from Rules 101 or 102 of Regulation M exists?

- Should the Commission remove the exception from Rules 101 and 102 of Regulation M for nonconvertible debt securities, nonconvertible preferred securities, and/or asset-backed securities completely? Why or why not? What specific trading activities that currently occur pursuant to the exception would then be prohibited during the restricted period because no other exception is available? What are the advantages and disadvantages of such trading activities? Should the Commission explicitly except any such specific activities in lieu of providing a generic exception for investment grade nonconvertible debt securities, nonconvertible preferred securities, and/or asset-backed securities? What benefits or challenges would this approach create?

- Should the Commission expand the exception to cover all nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities? What activities would then be allowed that were previously prohibited under Rules 101 and 102 of Regulation M? Would these new activities have any manipulative risk? Why or why not?

- Would the nonconvertible debt, nonconvertible preferred, and asset-backed securities excepted in the proposal be more vulnerable to manipulation than securities that meet the existing investment grade standard? Why or why not?

- Are the proposed standards an appropriate substitute for credit ratings in this context? Would the proposal capture the same type and quantity of securities that fall within the current Rule 101(c)(2) and Rule 102(d)(2) exceptions? What effect(s), if any, would the proposed modifications to the current exception have on the markets for nonconvertible debt, nonconvertible preferred and asset-backed securities?

- How difficult and costly in practice would the requirements of the proposed exception be to apply? If the requirements are more difficult or costly to apply, how might this impact the scope of securities subject to the restrictions of Regulation M? For example, to what extent, if any, might a narrower range of securities meet the exceptions as a result of the proposal, if adopted? If fewer securities are excepted from the restrictions of Regulation M, in what ways and to what extent, if any, would this impact the market for those securities that would no longer qualify for the exception?

- Will fewer nonconvertible debt securities, nonconvertible preferred

securities, and asset-backed securities issues meet the requirements for these exceptions? If so, what impact would this proposal have on the market for new issues of these securities?

- Please discuss whether and to what extent investors rely upon the current Rule 101(c)(2) and 102(d)(2) exceptions for investment grade nonconvertible and asset-backed securities when making a decision to invest in such securities. Please also discuss whether, given that Rules 101 and 102 of Regulation M are directed at distribution participants, issuers, and selling securities holders, Rules 101 and 102 of Regulation M pose any danger of undue reliance on NRSRO ratings.

- Are there factors other than those identified in the proposed standards that influence the trading of such securities? Are there additional standards that the Commission should consider? Are there any that the Commission should remove from the proposal?

- Should the proposed standards apply equally to nonconvertible debt, nonconvertible preferred, and asset-backed securities, or are there other standards that would be relevant to consider based on the type of security involved?

- Would persons needing to use the proposed exception have access to adequate information to determine whether a particular security meets the exception? Why or why not?

- Is the Commission's position (expressed at the time the exception was initially adopted)⁷⁹ that preferred securities are generally fungible with similar quality preferred securities still valid? Has the market for preferred securities changed to the extent that these securities are no longer generally fungible with similar quality preferred securities? If so, to what extent has the market changed? Rules 101(c)(2) and 102(d)(2) of Regulation M currently except investment grade nonconvertible preferred securities. Is this exception still relevant in the current marketplace for preferred securities? What would be the potential adverse consequences if preferred securities were no longer excepted from Rules 101 and 102?

- With regard to asset-backed securities, should the determination on behalf of the issuer that the security meets the proposed factors be made by the sponsor or depositor of the asset-backed security, or some other person? Please explain. What kinds of conflicts

⁷⁹ *Prohibitions Against Trading by Persons Interested in a Distribution*, Exchange Act Release No. 19565 (Mar. 4, 1983), 48 FR 10628 (Mar. 14, 1983).

of interest may arise in this situation relating to sponsors or depositors? For instance, the Commission could propose the following rule text: "With respect to an asset-backed security, the term issuer includes a sponsor, as defined in § 229.1011 of this chapter, or depositor, as defined in § 229.1011 of this chapter, that participates in the issuance of an asset-backed security." Does this further the goal of Regulation M and the reasons for the exception? What benefits or costs would be associated with this change?

- What impact, if any, will the potential costs of obtaining an independent third party verification have on the market for new issues of nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities? If these costs will have an impact, please explain how.

- Other than NRSROs, are there entities such as independent research firms or investment banks not involved in the distribution that would be willing and able to serve as independent third parties for these purposes?

- What additional costs, if any, will the requirement to use an independent third party for purposes of the third party verification proposal add to a distribution as compared to the current requirements of Rules 101(c)(2) and 102(d)(2)?

- Would the independent third party verification, if adopted, alter the amount or types of securities that can rely on the exception?

- What factors should be considered in qualifying an independent third party for purposes of the third party verification proposal?

- Does the independent third party verification requirement adequately address potential issuer, selling shareholder, distribution participant, and affiliated purchaser conflicts of interest?

- Would it be appropriate to utilize the definition, in whole or in part, of "qualified independent underwriter" from the SRO rules in establishing who may be an independent third party for purposes of the third party verification proposal? What are the benefits or drawbacks to utilizing this standard? What other alternatives should the Commission consider?

- The Commission would expect, if such an interpretation would be adopted, that the definition of "qualified independent underwriter" for these purposes would be similar to the requirements of FINRA Rule 5121(f)(12) and generally require that such persons (1) be registered with an SRO; (2) have no conflict of interest in the offering; (3) not be an affiliate of a person that does

have a conflict of interest; (4) not beneficially own more than 5% of the class of securities that would give rise to a conflict of interest; (5) have agreed in writing to be a qualified independent underwriter and undertake the legal responsibilities and liabilities of an underwriter under the Securities Act; (6) have specific offering experience; and (7) not have any supervisory associated persons who are responsible for organizing, structuring, or performing due diligence with respect to corporate public offerings of securities that have certain disciplinary histories. Would all of these requirements be appropriate? Are any of these requirements unnecessary?

- Should the Commission limit the eligibility to be an independent third party for purposes of the third party verification proposal to those registered with the Commission in some capacity? What are the benefits or drawbacks to utilizing this standard? What other alternatives should the Commission consider?

- In order to protect an independent third party verifier's independence, should the Commission limit the frequency with which a person could rely on the same independent third party for purposes of the third party verification proposal?

- Should the Commission instead require only that persons seeking to rely on the exception make a reasonable determination that the proposed factors are present in the security being offered, without any independent third party verification? If so, should the concern about conflicts of interest be addressed and how? What benefits would this approach provide? What other concerns could this approach raise?

- What are the risks of allowing parties to use internal processes to make determinations of reasonableness? For example, would parties be likely to adopt procedures that maximize the opportunity to take advantage of the exception? Would increased cost efficiencies arising from internal processes outweigh the conflicts of interest presented? How likely are there to be instances where a determination under the proposed amendments would result in a party qualifying for the exception when it would not have qualified under the current standard? How might the Commission attempt to mitigate such risks?

- Should the Commission, in lieu of the third party verification requirement, require that any person seeking to rely on the exception disclose in the offering documents relating to the distribution: (1) That the person is relying on the relevant exception; (2) that the person

has undertaken diligent review and, utilizing the factors identified in this proposal, reasonably concluded that the security meets the proposed factors; (3) the factors identified in the proposal and used by the person to make its conclusions; and (4) that the person or affiliated purchasers will be purchasing or bidding during the restricted period (if that is in fact the case)? Would this approach also address concerns about the cost and effectiveness of independent third party verification and have the added benefit of full disclosure to investors? Would this approach present costs that do not arise under the current exceptions? What other representations should be included in the offering documents if this approach is taken? What benefits would this approach provide? What other concerns could this approach raise?

- Should the Commission permit the third party verification requirement to be deemed satisfied if one of the purchasers of the security is an unaffiliated regulated entity, such as a money market fund⁸⁰ or a broker-dealer that determines that the lesser haircut would apply to the security under the Net Capital Rule proposal above?⁸¹ Such entities might be required to make their own determination regarding the creditworthiness of the security. Could this creditworthiness determination provide the benefits of an independent third party verifier (*i.e.*, an independent assessment of the security) without the cost of retaining such a verifier? What benefits would this approach provide? What other concerns could this approach raise? Would the timing of a distribution allow for this determination to be made prior to the beginning of the restricted period? Are there other entities that should be included under this alternative, and if so, which entities and why?

- Should persons subject to Rules 101 or 102 be able to rely on the determination of another person in the underwriting syndicate who is seeking to rely on the exception in connection with the same distribution or should all distribution participants, issuers, selling security holders, or affiliated purchasers be required to make their own determinations?

- The proposed criteria that, if satisfied, would except a specific security from Rules 101 and 102 of Regulation M, are designed to identify those characteristics of a security that

⁸⁰ See *References to Credit Ratings in Certain Investment Company Act Rules and Forms*, Investment Company Act Release No. 29592 (Mar. 3, 2011), 76 FR 12896 (Mar. 9, 2011).

⁸¹ See Section II.A.1, *supra*.

would correlate with whether or not such a security was susceptible to manipulation during a time when it was distributed. Previously these criteria were considered to be met if the security had an investment grade rating. In proposing the criteria above, the Commission has focused on those trading-oriented characteristics of securities that the Commission believes (a) may be typical of securities with an investment grade rating, and (b) that are relevant to the question about manipulation. However, the Commission also notes that another common characteristic of securities with an investment grade rating is credit quality, and hence price or yield spread. Is credit quality alone a good determinant of whether or not a security is susceptible to manipulation under the conditions in which Rules 101 and 102 of Regulation M is concerned? Why or why not? If so, given the required removal of any reference to a security's rating, how would credit quality be measured for the purposes of this rule? Would the price or yield of a security be a good proxy for credit quality? If so, should the Commission except nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities based on a specific premium to the London Interbank Offered Rate ("LIBOR") at pricing? Would the defined yield spread be difficult to determine for securities that are difficult to price? Would this approach lead to market participants adjusting the price of securities at issuance, delaying issuance, or engaging in other activities solely to obtain the exception? Is LIBOR an appropriate rate on which to base this test or would other rates be more appropriate? If such an approach was utilized, is at pricing the appropriate time at which to compare the rates? How should the spreads be calculated? Would nonconvertible preferred securities and asset-backed securities be able to continue to rely on the exception under this proposal? Would persons seeking to rely on the exception be able to determine this information before the beginning of the restricted period? What benefits would this approach provide? What other concerns could this approach raise? How difficult will it be to predict, ahead of issuance, what the new issue's yield spread to the reference rate will be at the time the issue is priced? What is the expected economic effect of difficulty in predicting the yield spread at the time of pricing? Would the number of issues brought to market be impacted?

- With regard to asset-backed securities, should the Commission, in place of or in addition to the proposed amendment, except asset-backed securities that would meet the requirements for shelf eligibility for such securities as recently proposed by the Commission?⁸² This would provide a bright line test for these securities but may alter the universe of asset-backed securities that could rely on the exceptions. What benefits would this approach provide? What other concerns could this approach raise? How would this approach address potential conflicts of interest involving the issuer, selling shareholder, distribution participant, or affiliated purchaser?

- Should the Commission except nonconvertible debt securities and nonconvertible preferred securities based on trading volume and outstanding relevant securities of the issuer? For example, the Commission could except nonconvertible debt securities where the issuer has at least \$1 billion in outstanding debt and the trading volume of the outstanding debt securities of that issuer equaled or exceeded 100% turnover over a six month period, excluding trading by persons claiming the exception. This would have the benefit of establishing a bright line standard and is similar to the actively-traded securities exception found in Rule 101,⁸³ but may except a different universe of securities, be difficult to determine for securities that are hard to value, and would not be available to securities of new issuers. What benefits would this approach provide? What other concerns could this approach raise? Would such an exception tailored for nonconvertible

⁸² *Asset-Backed Securities*, Exchange Act Release No. 61858 (Apr. 7, 2010), 75 FR 23328 (May 3, 2010). This proposal would extend shelf eligibility to asset-backed securities where (1) a certification is filed at the time of each offering of a shelf registration statement by the chief executive officer of the depositor that the assets in the pool have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows to service any payments due and payable on the securities as described in the prospectus; (2) the sponsor retains a specified amount of each tranche of the securitization, net of the sponsor's hedging; (3) a provision in the pooling and servicing agreement requires the party obligated to repurchase the assets for breach of representations and warranties to periodically furnish an opinion of an independent third party regarding whether the obligated party acted consistently with the terms of the pooling and servicing agreement with respect to any loans that the trustee put back to the obligated party for violation of representations and warranties and which were not repurchased; and (4) the issuer makes an undertaking to file Exchange Act reports so long as non-affiliates of the depositor hold any securities that were sold in registered transactions backed by the same pool of assets.

⁸³ 17 CFR 242.101(c)(1).

preferred (referencing \$1 billion outstanding equity and trading volume of the issuer's nonconvertible preferred securities) be appropriate? What other changes would need to be made in order to make the exception available to preferred securities generally? Are there different numerical thresholds that are better able to replicate the universe of currently excepted nonconvertible debt securities and preferred securities? If the Commission replaced the current criteria with a volume test, how much effort on the part of intermediaries would be required to demonstrate that a volume threshold was met? How difficult would it be for financial intermediaries to gather volume statistics? What would the range of associated costs be? If it was necessary under the volume test to exclude trading by persons subject to Rules 101 or 102, would that information be available to financial intermediaries? Are there other numerical tests of this type that would be more appropriate? How would this approach address potential conflicts of interest involving the issuer, selling shareholder, distribution participant, or affiliated purchaser?

- Should underwriters be required to keep records demonstrating their eligibility for the exception as modified by the proposal? Should underwriters be required to obtain records from the issuer or selling shareholder demonstrating eligibility for the exception as modified by the proposal and keep them? What records should be kept?

- Please comment generally on any relevant changes to the debt markets since Regulation M was adopted in 1996 and how these developments should affect the Commission's evaluation of the proposed amendments.

D. Proposed Amendments to Rule 10b-10

Exchange Act Rule 10b-10,⁸⁴ the Commission's customer confirmation rule, generally requires broker-dealers effecting transactions for customers in securities, other than U.S. savings bonds or municipal securities,⁸⁵ to provide those customers with a written notification, at or before completion of the securities transaction, disclosing certain information about the terms of the transaction. Specifically, Rule 10b-10 requires the disclosure of the date, time, identity, and number of securities bought or sold; the capacity in which the broker-dealer acted (*e.g.*, as agent or

⁸⁴ 17 CFR 240.10b-10.

⁸⁵ Municipal securities are covered by Municipal Securities Rulemaking Board rule G-15, which applies to all municipal securities brokers and dealers.

principal); yields on debt securities; and under specified circumstances, the amount of compensation the broker-dealer will receive from the customer and any other parties. By requiring these disclosures, the rule serves a basic customer protection function by conveying information that: (1) Allows customers to verify the terms of their transactions; (2) alerts customers to potential conflicts of interest; (3) acts as a safeguard against fraud; and (4) allows customers a means of evaluating the costs of their transactions and the quality of the broker-dealer's execution.

Paragraph (a)(8) of Rule 10b-10, which the Commission adopted in 1994, requires a broker-dealer to inform the customer in the confirmation if a debt security, other than a government security, is unrated by an NRSRO.⁸⁶ As explained in the 1994 Adopting Release, paragraph (a)(8) was intended to alert customers to the potential need to obtain more information about a security from a broker-dealer;⁸⁷ it was not intended to suggest that an unrated security is inherently riskier than a rated security. Rule 10b-10 does not require broker-dealers to disclose in customer confirmations the NRSRO rating for securities that are rated, although the Commission understands that some broker-dealers may do so voluntarily. The Commission has previously proposed, and re-proposed, the deletion of paragraph (a)(8) from Rule 10b-10.⁸⁸ The Commission's previous proposals to delete paragraph (a)(8) were prompted by concerns regarding the undue reliance on NRSRO ratings and confusion about the significance of those ratings. Section 939A of the Dodd-Frank Act requires the Commission to replace references to NRSRO ratings in its rules, where these act as a proxy for creditworthiness, with a different standard of creditworthiness. Because paragraph (a)(8) of Rule 10b-10 does not refer to NRSRO ratings as a means of determining creditworthiness, this provision does not come strictly within Section 939A's requirements. Nevertheless, the Commission

⁸⁶ See *Confirmation of Transactions*, Exchange Act Release No. 34962 (Nov. 10, 1994), 59 FR 59612 (Nov. 17, 1994) ("1994 Adopting Release").

⁸⁷ *Id.* The Commission stated that "[i]n most cases, this disclosure should verify information that was disclosed to the investor prior to the transaction. If the customer was not previously informed on the security's unrated status, the confirmation may prompt a dialogue between the customer and the broker-dealer."

⁸⁸ See, e.g., *References to Ratings of Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 60790 (Oct. 5, 2009), 74 FR 52374 (Oct. 9, 2009); *Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 58070 (Jul. 1, 2008), 73 FR 40088 (Jul. 11, 2008).

preliminarily believes that to the extent that the provision is intended to focus investor attention on ratings issued by NRSROs, as distinct from other items of information, deleting it is consistent with the intent of the Dodd-Frank Act. Accordingly, the Commission is now re-proposing to delete paragraph (a)(8) from Rule 10b-10.⁸⁹

However, the Commission wishes to consider the relative benefits of retaining this information in the customer confirmation against the benefits of removing it. The Commission notes that the current requirement to disclose the unrated status of a debt security provides investors with an item of factual information that is conveyed together with additional factual information about the terms of the transaction. The Commission also notes that if this provision were deleted from Rule 10b-10, broker-dealers would not be prohibited from continuing to provide this disclosure on a voluntary basis.⁹⁰ The Commission requests comment on the following:

- Would the investor protection function of Rule 10b-10 be, in any way, diminished by deleting paragraph (a)(8) from the rule? Are there any alternative means of providing this information to customers?
- What types of securities would typically be unrated by an NRSRO? What types of issuers would typically not have their securities rated by an NRSRO?

• Could the disclosure that a security is unrated be removed from a customer confirmation without causing customer confusion? If so, given the historical use and investor expectations related to this disclosure, could it be removed without implying that a security is in fact rated? Should broker-dealers be required to alert customers that the unrated status of a security is no longer being disclosed? If so, for how long?

• The preliminary note to Rule 10b-10 provides: "This section requires broker-dealers to disclose specified information in writing to customers at or before completion of a transaction. The requirements under this section that particular information be disclosed is not determinative of a broker-dealer's obligation under the general antifraud provisions of the federal securities laws

⁸⁹ Consistent with that change, the Commission is also proposing to redesignate paragraph (a)(9) of the rule, related to broker-dealers that are not members of the Securities Investor Protection Corporation ("SIPC"), as paragraph (a)(8).

⁹⁰ Indeed, based on a limited review of customer confirmations, the Commission understands that in addition to disclosing the unrated status of a security, some broker-dealers may also voluntarily include the NRSRO ratings for rated securities.

to disclose additional information to a customer at the time of the customer's investment decision." If paragraph (a)(8) were deleted, would the preliminary note to Rule 10b-10 affect a broker-dealer's decision to nonetheless continue to voluntarily disclose whether a security is unrated?

• If paragraph (a)(8) were deleted, is there a disclosure that should be required in the confirmation on a transitional or permanent basis that would help prevent customer confusion? For example, should the Commission require broker-dealers, either permanently or temporarily for a transition period, to disclose that broker-dealers are no longer required to include on the confirmation the fact that a security is unrated? Should such a disclosure be made on the confirmation, the account statement, or in a separate document accompanying the confirmation or account statement? What are the costs associated with providing this disclosure on the confirmation, the account statement or in a separate document?

• If the requirement to disclose that a security is unrated were deleted from Rule 10b-10, would broker-dealers nevertheless feel compelled to include the disclosure in order to satisfy their sales practice obligations?

• Should the requirement to disclose that a security is unrated be replaced by a requirement to provide a general statement regarding the importance of considering an issuer's creditworthiness?

• If the requirement to disclose that a security is unrated were deleted from the rule, are there alternative external or objective measures of credit risk that could be substituted for ratings by an NRSRO? Is it practicable to replace it with a requirement to disclose specific information regarding an issuer's creditworthiness? If so, what specific information should the Commission consider including?

III. Requests for Comment on Section 939(e) of Dodd-Frank

Section 939(e) of the Dodd-Frank Act⁹¹ deleted Exchange Act references to credit ratings by NRSROs in Exchange Act Section 3(a)(41),⁹² which defines the term "mortgage related security," and in Exchange Act Section 3(a)(53),⁹³ which defines the term "small business related security." The credit rating references in Sections 3(a)(41) and 3(a)(53) effectively exclude from the respective definitions

⁹¹ See Public Law 111-203 § 939(e).

⁹² 15 U.S.C. 78a(3)(a)(41).

⁹³ 15 U.S.C. 78a(3)(a)(53).

securities that otherwise meet the definitions but are not rated by at least one NRSRO in the top two credit rating categories in the case of mortgage related securities or in the top four credit rating categories in the case of small business related securities. In place of the credit rating references, Congress added language stating that a mortgage related security and a small business related security will need to satisfy “standards of credit-worthiness as established by the Commission.”⁹⁴ This replacement language will go into effect on July 21, 2012 (*i.e.*, two years after the Dodd-Frank Act was signed into law).⁹⁵ Thus, before that time, the Commission will need to establish a new standard of creditworthiness for each Exchange Act definition. As is discussed below, the Commission is requesting comment on potential “standards of credit-worthiness” for purposes of Sections 3(a)(41) and 3(a)(53) as the Commission considers how to implement Section 939(e) of the Dodd-Frank Act.

A. Exchange Act Section 3(a)(41)

Congress defined the term “mortgage related security” in Section 3(a)(41) as part of the Secondary Mortgage Market Enhancement Act of 1984 (“SMMEA”).⁹⁶ SMMEA was intended to encourage private sector participation in the secondary mortgage market by, among other things, relaxing certain regulatory burdens that affected the ability of private-label issuers⁹⁷ to sell their mortgage-backed securities.⁹⁸ For example, SMMEA removed obstacles for privately sponsored mortgage-backed

securities by, among other things, preempting certain state investment laws so that state regulated institutions might purchase privately sponsored mortgage-backed securities to the same extent as agency securities, granting authority for certain depository institutions to invest in these securities, and requiring states to exempt privately sponsored mortgage-backed securities from state registration to the same extent as agency securities, unless the state specifically deemed otherwise.⁹⁹ A security that qualifies as a mortgage related security, as defined in Section 3(a)(41), receives the benefits intended by SMMEA.¹⁰⁰

Generally, Section 3(a)(41) defines the term “mortgage related security” as a “security that is rated in one of the two highest rating categories by at least one [NRSRO],” which (1) represents ownership of one or more promissory notes, or interests therein, which notes (a) are directly secured by a first lien on a single parcel of real estate upon which is located a dwelling or mixed residential and commercial structure, or on a residential manufactured home or one or more parcels of real estate upon which is located one or more commercial structures and (b) were originated by a savings or banking institution approved for insurance by the Secretary of the U.S. Department of Housing and Urban Development; or (2) is secured by one or more promissory notes, or interests therein, and provides for payments of principal in relation to payments, or reasonable projections of payments, on notes, or interests therein, meeting the requirements specified above.

When Congress adopted SMMEA, it used NRSRO ratings to specify mortgage related securities that qualify for benefits under the legislation. As reflected in Section 939(e) of the Dodd-Frank Act, Congress has chosen to no longer rely on credit ratings by NRSROs to make this distinction, and instead has instructed the Commission to establish a new standard of creditworthiness that does not rely on credit ratings by NRSROs. Before acting on this authority, the Commission invites interested persons to submit written comments on potential alternatives the Commission should consider for purposes of implementing Section 939(e) of the Dodd-Frank Act.

One potential alternative the Commission is considering is a new rule under the Exchange Act that would apply the “minimal amount of credit

risk” standard the Commission is proposing with respect to the Net Capital Rule, as described above, to persons assessing whether a security is a mortgage related security within the meaning of Section 3(a)(41). The Commission preliminarily believes that the proposed minimal amount of credit risk standard for mortgage related securities would be consistent with the intended objective in Section 3(a)(41) of excluding from the definition mortgage related securities of lesser credit quality. The Commission further believes that the factors set forth above for facilitating determinations by broker-dealers as to whether a security satisfies the minimal amount of credit risk standard under the Net Capital Rule could facilitate determinations by others as to when mortgage related securities are subject to a minimal amount of credit risk under Section 3(a)(41). The Commission notes, however, that nonconvertible debt and preferred stock are currently required to be rated in one of the four highest credit rating categories by two NRSROs to qualify for reduced haircuts under the Net Capital Rule, and that a mortgage related security that qualifies as such under the current definition of that term in Section 3(a)(41) is required to satisfy a slightly more stringent level of credit quality (*i.e.*, to be rated in one of the two highest rating categories of one NRSRO).

B. Exchange Act Section 3(a)(53)

Congress defined the term “small business related security” in Section 3(a)(53) as part of the Riegle Community Development and Regulatory Improvement Act of 1994 (the “CDRI”).¹⁰¹ Among other things, the CDRI removed limitations on purchases by national banks of certain small business-related securities. The stated intent of Congress in the CDRI was to increase small business access to capital by removing impediments in existing law to the securitizations of small business loans.¹⁰² The CDRI built on the framework for securitizations established by SMMEA to create a similar framework for these securities with the goal of stimulating the flow of funds to small businesses.

Generally, Section 3(a)(53) defines the term “small business related security” as “a security that is rated in one of the four highest rating categories by at least

¹⁰¹ Public Law 103–325, § 202, 108 Stat. 2198 (1994).

¹⁰² See Conference Report on the CDRI, Vol. 140 Cong. Record, pp. H6685, H6690 (Aug. 2, 1994). See also Remarks of Sen. Domenici, Vol. 140 Cong. Record, p. S11039, S11043–43 (Aug. 2, 1994) (discussing national banks’ authority to purchase commercial mortgage related securities under conditions established by the Office of the Comptroller of the Currency).

⁹⁴ See Public Law 111–203 § 939(e)(1) and (e)(2).

⁹⁵ See Public Law 111–203 § 939(g).

⁹⁶ Public Law 98–440, § 101, 98 Stat. 1689 (1984).

⁹⁷ Most mortgage-backed securities are issued by the Government National Mortgage Association (“Ginnie Mae”), a U.S. government agency, or the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”), U.S. government-sponsored enterprises. Ginnie Mae, backed by the full faith and credit of the U.S. government, guarantees that investors receive timely payments. Fannie Mae and Freddie Mac also provide certain guarantees and, while not backed by the full faith and credit of the U.S. government, have special authority to borrow from the U.S. Treasury. Some private institutions, such as brokerage firms, banks, and homebuilders, also securitize mortgages, known as “private-label” mortgage securities.

⁹⁸ The legislation was aimed at encouraging participation in the secondary mortgage market by investment banks, investment entities, mortgage bankers, private mortgage insurance companies, pension funds and other investors, depository institutions and federal credit unions. See Kenneth G. Lore & Cameron L. Cowan, *Mortgage-Backed Securities: Developments and Trends in the Secondary Market 2–39* (2001), at 1–14. See also Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 Notre Dame L. Rev. 497, 499 (1989).

⁹⁹ See *Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management (May 1992).

¹⁰⁰ See Pittman *supra* note 98, at 514.

one [NRSRO]" and either (i) represents an interest in promissory notes or leases of personal property evidencing the obligation of a small business concern and originated by an insured depository institution supervised and examined by federal or state authority or certain other regulated types of issuers, or (ii) is secured by promissory notes or leases of personal property (with or without recourse to the issuer or lessee) and provides for payments of principal in relation to payments, or reasonable projections of payments, on notes or leases of the type described in the preceding clause.

When Congress adopted the term "small business related security" in the CDRI, it used NRSRO ratings to specify small business related securities that would qualify for benefits under the legislation. As reflected in Section 939(e) of the Dodd-Frank Act, Congress has chosen to no longer rely on credit ratings by NRSROs to make this distinction, and instead has instructed the Commission to establish a new standard of creditworthiness that does not rely on credit ratings of NRSROs. Before acting on this authority, the Commission invites interested persons to submit written comments on potential alternatives the Commission should consider for purposes of implementing Section 939(e) of the Dodd-Frank Act.

One potential alternative the Commission is considering is a new rule under the Exchange Act that would apply the "minimal amount of credit risk" standard the Commission is proposing with respect to the Net Capital Rule, as described above, to persons assessing whether a security is a small business related security within the meaning of Section 3(a)(53). The level of credit quality Congress intended for a small business related security to satisfy in Section 3(a)(53) to qualify for benefits under the CDRI is the same level of credit quality that nonconvertible debt and preferred stock must currently satisfy to qualify for reduced haircuts under the Net Capital Rule (*i.e.*, NRSRO credit ratings in one of the four highest rating categories). The Commission preliminarily believes that the minimal amount of credit risk standard for small business related securities would be consistent with the intended objective of Congress in Section 3(a)(53) by excluding from the definition small business related securities of lesser credit quality. The Commission further preliminarily believes that the proposed factors set forth above for facilitating determinations by broker-dealers as to whether a security satisfies the minimal

amount of credit risk standard under the Net Capital Rule could facilitate determinations by others as to when a small business related security is subject to a minimal amount of credit risk under Section 3(a)(53).

C. Requests for Comment

The Commission requests comment on all aspects of how to implement Section 939(e) with respect to the definitions of mortgage related security and small business related security. In addition, the Commission requests comment on the following specific questions. In responding, commenters should distinguish between the two definitions to the extent that they believe that the two definitions should be treated differently for purposes of new rules.

- Is the minimal credit risk standard a practical and workable alternative for purposes of Section 3(a)(41) and Section 3(a)(53)? If not, what creditworthiness standard would be more appropriate?

- Who should be responsible for determining whether a security is creditworthy for these purposes? For example, is the sponsor, which is often involved in most, if not all, aspects of the securitization process, the most appropriate person to make this determination? Is the trustee a more appropriate person to make this determination based on the fiduciary relationship between the trustee and investors in the trust? Would an underwriter be an acceptable person to make the determination? Who else would be appropriate to make this determination?

- If the sponsor or another person makes the creditworthiness determination, could imposing disclosure obligations on that person with respect to its creditworthiness determination mitigate potential conflicts of interest?

- Should two or more persons be able to make the creditworthiness determination for the same security? If so, how could potential inconsistencies in that determination be resolved?

- If a sponsor or other person makes the creditworthiness determination, should that person be potentially liable to persons who relied on the determination? If so, what standard of liability should be applied?

- How often should creditworthiness determinations be made under Section 3(a)(41) or Section 3(a)(53) in order to determine if a security qualifies as a mortgage related security or small business related security?

- What objective measures could be used to determine whether securities qualify as mortgage related securities or

small business related securities? Please explain what measures or creditworthiness standards the Commission should consider.

- Should the Commission adopt rules that are designed to allow regulators or other persons to examine or verify that creditworthiness determinations are consistent with the requirements of the rules? Should creditworthiness determinations be subject to regulatory review? Should the Commission require a person making the determination to create, maintain, and make available for examination certain records related to the determination?

- Should the Commission impose a more stringent creditworthiness standard than the minimal credit risk standard that is being proposed for purposes of the Net Capital Rule? If so, what standard should apply, and how could it be distinguished from the minimal credit risk standard?

- Would application of the minimal credit risk standard proposed for purposes of the Net Capital Rule result in securities of lesser credit quality qualifying as mortgage related securities or small business related securities as compared to securities that currently qualify as such under Section 3(a)(41) or Section 3(a)(53)? If so, please explain why this would be the case and provide examples.

- An alternative to credit ratings, if too rigid, could narrow the types of financial instruments that qualify under Section 3(a)(41) or Section 3(a)(53) and, if too flexible, could broaden the types of financial instruments that qualify under Section 3(a)(41) or Section 3(a)(53). In discussing potential alternatives to credit ratings, please analyze their potential impacts on competition and capital formation.

IV. Paperwork Reduction Act

Certain provisions of the proposed amendments to the rules and form contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").¹⁰³ The hours and costs associated with preparing and filing the disclosure, filing the form and schedules and retaining records required by these regulations constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The titles of the affected information forms are Rule 15c3-1 (OMB Control Number 3235-0200),

¹⁰³ 44 U.S.C. 3501 *et seq.*

Rule 15c3-3 (OMB Control Number 3235-0078), Rule 17a-4 (OMB Control Number 3235-0279) and Form X-17A-5, Financial and Operational Combined Uniform Single Report, Part IIB, OTC Derivatives Dealer (OMB Control Number 3235-0498); Rule 101 (OMB Control Number 3235-0464) and Rule 102 (OMB Control Number 3235-0467) of Regulation M; and Rule 10b-10 Confirmation of Transactions,” (OMB Control Number 3235-0444). For the reasons discussed below, the Commission does not believe the proposed amendments, if adopted, would result in a material or substantive revision to these collections of information.¹⁰⁴ The cost estimates contained in this section do not include any other possible costs or economic effects beyond the costs required to be calculated for PRA purposes.¹⁰⁵

A. Summary of Collection of Information

As discussed above, the Commission is proposing amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, Rules 101 and 102 of Regulation M, and Rule 10b-10. These amendments, in part, are proposed to comply with Section 939A of the Dodd-Frank Act, which requires the Commission to replace references to credit ratings in all of its regulations with a standard of creditworthiness that the Commission deems appropriate.

The proposed amendments to the Net Capital Rule and Rule 17a-4 create a new standard of creditworthiness that will allow broker-dealers to establish their own policies and procedures to determine whether a security has only a minimal amount of credit risk. If a broker-dealer chooses to establish these policies and procedures it would create a new “collection of information” burden for those broker-dealers, as explained below. In addition, the proposed amendments to the Customer Protection Rule remove one method for verifying the status of a registered clearing agency or derivatives clearing organization under Note G to Exhibit A. Broker-dealers who may have to use a new method for verifying the status of a registered clearing agency or derivatives clearing organization may have a new “collection of information” within the meaning of the PRA.

The proposed changes to Rules 101 and 102 of Regulation M would amend the exceptions for nonconvertible debt, nonconvertible preferred, and asset-

backed securities in those rules. Under the proposed amendments, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to assess nonconvertible debt, nonconvertible preferred, and asset-backed securities to determine whether that security is liquid relative to the market for that asset class, trades in relation to general market interest rates and yield spreads, and is relatively fungible with securities of similar characteristics and interest rate yield spreads in order to rely on the exception. Further, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to obtain an independent third-party to verify their analysis under the proposal. Persons seeking to rely on these proposed revised exceptions would need to demonstrate compliance with the proposed revised exceptions. These requirements would impose a new “collection of information” within the meaning of the PRA.

The proposed amendment to Rule 10b-10 would eliminate a requirement for transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. Although Section 939A of the Dodd-Frank Act requires the Commission to replace references to NRSRO ratings in its rules with a different standard of creditworthiness, the reference to NRSROs in Rule 10b-10 does not come strictly within Section 939A’s requirements. The Commission believes, however, that deleting paragraph (a)(8) would make Rule 10b-10 consistent with how references to NRSROs and their ratings are being dealt with in other Commission rules pursuant to the requirements of the Dodd-Frank Act.

B. Proposed Use of Information

The purpose of written policies and procedures, and the retention of these policies and procedures, is to ensure that examination staff, from either the Commission or an SRO, could review the policies and procedures to determine if the broker-dealer has an acceptable process for determining if a security has only a minimal amount of credit risk. In addition, written policies and procedures would give the staff consistent guidance on how to determine a minimal amount of credit risk.

As discussed above, the proposed changes to Rules 101 and 102 of Regulation M would amend the exceptions for nonconvertible debt, nonconvertible preferred, and asset-backed securities in those rules. Under

the proposed amendments, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to assess nonconvertible debt, nonconvertible preferred, and asset-backed securities to determine whether that security is liquid relative to the market for that asset class, trades in relation to general market interest rates and yield spreads, and is relatively fungible with securities of similar characteristics and interest rate yield spreads in order to rely on the exception. Further, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to obtain an independent third-party to verify their analysis under the proposal. Persons seeking to rely on these proposed revised exceptions would need to demonstrate compliance with the proposed revised exceptions. The information collected under the proposal would be used to ensure that the nonconvertible debt, nonconvertible preferred, and asset-backed securities less likely to be subject to manipulation are excepted from Rules 101 and 102 of Regulation M, at the same time meeting the mandates of Section 939A of the Dodd-Frank Act.

The proposed amendment to Rule 10b-10 would eliminate a requirement for transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. This proposed amendment would alter neither the general requirement that broker-dealers generate transaction confirmations and send those confirmations to customers, nor the potential use of information contained in confirmations by the Commission, self-regulatory organizations, and other securities regulatory authorities in the course of examinations, investigations and enforcement proceedings. Moreover, the proposed amendment is not expected to change the cost of generating and sending confirmations, and, the Commission believes that broker-dealers may not need to incur significant costs if they choose not to input information that a debt security is unrated into their existing confirmation systems. Accordingly, the Commission does not believe the proposed amendment would result in a material or substantive revision to these collections of information if adopted.

C. Respondents

The Commission estimates that the proposed collections of information would apply to the following number of respondents:

¹⁰⁴ 5 CFR 1320.5(g).

¹⁰⁵ See discussion below in Section V.C.2.

- Proposed amendments to Rule 15c3-1 and Rule 17a-4: 480 broker-dealers.
- Proposed amendments to Appendices A, E, F, and G to Rule 15c3-1: 172 broker-dealers.
- Proposed amendments to Exhibit A to Rule 15c3-3: 90 broker-dealers.
- Proposed amendments to Form X-17A-5: 4 broker-dealers.
- Proposed amendments to Regulation M: 2533 respondents. The Commission bases this estimate on the total number of respondents to Rules 101 (1588) and 102 (945).
- Proposed amendments to Rule 10b-10: 530 broker-dealers.

The Commission generally requests comment on all aspects of these estimates for the number of broker-dealers. Commenters should provide specific data and analysis to support any comments they submit with respect to these estimates with respect to the number of respondents.

D. Total Initial and Annual Reporting and Recordkeeping Burden

1. Rule 15c3-1 and Rule 17a-4

The proposed amendments to Rule 15c3-1 and Rule 17a-4 would modify broker-dealers' existing practices to impose additional recordkeeping burdens. The proposed amendments would replace NRSRO ratings-based criteria for evaluating creditworthiness with an option for a broker-dealer to apply new standards based on the broker-dealer's own evaluation of creditworthiness. A broker-dealer that did not want to make such an evaluation could instead take the higher haircuts. A broker-dealer that chooses to evaluate the creditworthiness of securities would have to explain how the haircuts used for net capital purposes meet the standards set forth in the proposed amendments. As such, the Commission believes that firms would be required to develop (if they have not already) criteria for assessing creditworthiness and apply those criteria to the securities included in the net capital calculation. The Commission preliminarily believes, however, that most firms that deduct haircuts for purposes of the Net Capital Rule when evaluating debt securities already have such an assessment process in place. The Commission preliminarily believes that broker-dealers that do not have such a system in place do not normally hold debt securities or, if they do, would choose to take the higher haircuts rather than create such a process. In addition, the expectation that the broker-dealer be able to explain how its haircuts meet the standards set forth in

the proposed amendments would result in the creation and maintenance of records of those assessments.

The Commission preliminarily believes that all broker-dealers already have policies and procedures in place for evaluating the overall risk and liquidity levels of the securities they use for the purposes of the Net Capital Rule and that they retain these policies and procedures; however, the proposed amendments, which specifically address credit risk, could result in additional burdens for those broker-dealers that choose to use them. The proposed amendments would apply to the approximately 480 broker-dealers¹⁰⁶ that hold debt securities and take haircuts on these securities pursuant to paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2) and (c)(2)(vi)(H) of Rule 15c3-1. The Commission estimates that, on average, broker-dealers will spend 25 hours developing policies and procedures or revising their current policies and procedures for evaluating creditworthiness for the purposes of the Net Capital Rule, resulting in an aggregate initial burden of 12,000 hours.¹⁰⁷ This estimate is based on the Commission's belief that many of these broker-dealers already have their own criteria in place for evaluating creditworthiness and, therefore, most broker-dealers will only be revising their current policies and procedures for evaluating creditworthiness.

The Commission further estimates that, on average, each broker-dealer will spend an additional 10 hours a year reviewing and adjusting its own standards for evaluating creditworthiness, for a total of 4,800 annual hours across the industry.¹⁰⁸ This estimate does not reflect the time it will take for each broker-dealer to apply and implement its own standards for evaluating creditworthiness. This estimate reflects the Commission's belief that these broker-dealers already have their own criteria in place. The Commission also estimates that firms would use a controller to review these standards, both initially and on an annual basis. The Commission estimates the per-firm costs of the controller to be \$10,825 initially and \$4,330 on an annual basis, for an aggregate industry cost of \$5,196,000 initially and \$2,078,400 on an annual basis.¹⁰⁹ The

¹⁰⁶ This number was obtained by reviewing all FOCUS 2009 year-end submissions and then calculating how many firms report holding proprietary debt positions. See *supra* note 32.

¹⁰⁷ 480 broker-dealers × 25 hours = 12,000 hours.

¹⁰⁸ 480 broker-dealers × 10 hours = 4,800 hours.

¹⁰⁹ For the purposes of this analysis, the Commission is using salary data from the Securities Industry and Financial Markets Association

Commission preliminarily believes that the proposed requirement to retain the policies and procedures for three years pursuant to Rule 17a-4 would result in de minimis costs. The three year preservation requirement in Rule 17a-4 will only be applicable once a broker-dealer changes its policies and procedures. In addition, all broker-dealers are currently required to comply with the three year preservation period in Rule 17a-4 for other records and should have procedures to satisfy such preservation requirements in place.

The proposed amendments to the appendices to Rule 15c3-1 include amendments to certain recordkeeping and disclosure requirements that are subject to the PRA. The proposed amendment to Appendix A to Rule 15c3-1 removes the NRSRO reference from the definition of "major market foreign currency." The Commission preliminarily believes that 158 broker-dealers trade in foreign currency and, therefore, would be affected by the proposed amendment.¹¹⁰ However, it is not the intention of the Commission that the currencies meeting the definition of "major market foreign currency" should change. If, however, a broker-dealer wanted to request that a new currency meet the definition of "major market foreign currency" it would have to submit such a request to the Commission. The Commission preliminarily believes that submitting such a request to the Commission would take approximately ten hours for a total burden of 1,580 hours.¹¹¹ Additionally, the Commission believes that a broker-dealer would use an attorney to prepare this request, for a cost of \$3,540 per firm

("SIFMA") Report on Management and Professional Earnings in the Securities Industry 2010, which provides base salary and bonus information for middle management and professional positions within the securities industry, as modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. Hereinafter, references to data derived from the report as modified in the manner described above will be cited as *SIFMA Report on Management and Professional Earnings in the Securities Industry 2010*. The Commission believes that the reviews required by the proposed amendments would be performed by the controller at an average rate \$433 per hour. Furthermore, the Commission believes that the review process will entail twenty-five hours initially and ten hours on an annual basis. $\$433 \times 25 = \$10,825 \times 480 = \$5,196,000$; $\$433 \times 10 = \$4,330 \times 480 = \$2,078,400$.

¹¹⁰ To arrive at this number, the Commission requested from the Options Clearing Corporation ("OCC") the number of broker-dealers that are authorized to clear foreign currency options. The Commission was given the number of 158. Although 158 broker-dealers are authorized to clear foreign currency options, the Commission does not know if all of these broker-dealers are actually clearing foreign currency options.

¹¹¹ 158 broker-dealers × 10 hours = 1,580.

and an aggregate industry cost of \$559,320.¹¹²

The proposed amendments to Appendices E and F to Rule 15c3-1 and conforming amendments to Appendix G would remove the provisions permitting reliance on NRSRO ratings for the purposes of determining counterparty risk. As a result of these deletions, an entity that wished to use the approach set forth in these appendices to determine counterparty risks would be required, as part of its initial application to use the alternative approach or in an amendment, to request Commission approval to determine credit risk weights based on internal calculations and make and keep current a record of the basis for the credit risk weight of each counterparty.

The Commission does not believe that the removal of the option permitting reliance on NRSRO ratings would affect the small number of entities that currently elect to compute their net capital deductions pursuant to the alternative methods set forth in Appendix E or F. Although the collection of information obligations imposed by the proposed amendments are mandatory, applying for approval to use the alternative capital calculation is voluntary. To date, a total of six entities are using the methods set forth in Appendix E, while four are using the methods set forth in Appendix F. All of the approved firms already have developed models to calculate market and credit risk under the alternative net capital calculation methods set forth in the appendices as well as internal risk management control systems.¹¹³ As such, each firm already employs the non-NRSRO ratings-based method that would, under the proposed amendments, become the only option for determining counterparty credit risk under Appendices E and F. Since each entity already employs its own models to calculate market and credit risk and keeps current a record of the basis for the credit risk weight of each counterparty, the proposed amendments would not alter the paperwork burden

currently imposed by Appendices E and F.

The Commission currently anticipates that three additional firms may apply for permission to use Appendix E and one additional firm may apply to use Appendix F. However, the Commission preliminarily believes that there should be no additional paperwork burden on these firms based on the proposed amendments. Any firm that applies to use Appendices E or F to Rule 15c3-1 must submit its internal models to the Commission for approval as part of that process. These models will calculate market risk and credit risk, as well as counterparty risk, which is not a change from the previous approval process for a firm that is applying to use Appendix E or Appendix F. In fact, the Commission believes that the only change to this process will be that the Commission will assign ratings scales to these models that can be used to determine counterparty risk when approving the models. Thus, the Commission does not believe the proposed amendments to Appendices E and F will alter the paperwork burden for such firms.

The instructions to Form X-17A-5 Part IIB currently include a summary of the credit risk calculation in paragraph (d) of Rule 15c3-1f. Paragraph (d) of Rule 15c3-1f is proposed to be amended to remove that part of the credit risk calculation that is summarized in Form X-17A-5 Part IIB. Accordingly, the Commission has proposed a conforming amendment to the form that would remove the summary of the credit risk calculation. The summary in the instructions provides additional information for the benefit of the filer and is not related to the information reported on the forms. Accordingly, the Commission does not believe the proposed amendment would result in a substantive revision to these collections of information if adopted.

The Commission requests comment on all aspects of these proposed estimates. In addition, the Commission requests specific comment on the following items related to these estimates:

- Is the Commission correct in its hours estimates and belief that many broker-dealers already have their own policies and procedures in place for evaluating creditworthiness?
- Is the Commission correct in its belief that broker-dealers would engage outside counsel to review their internally generated standards for creditworthiness? If not, how would firms review such standards and what would be the effect of such differing approaches on our burden estimates?

• Is the Commission correct in its belief that new firms that apply to use the standards in Appendices E and F to Rule 15c3-1 will not have an extra burden as a result of the proposed amendments?

- Is the Commission correct in its estimation of the number of broker-dealers that trade foreign currency options?
- Is the Commission correct in its estimation on the number of hours it would take for a firm to make a submission to the Commission requesting that a currency be designated as a major market foreign currency?
- Is the Commission correct in its belief that a firm would engage outside counsel to make this submission? Or would a firm handle this internally?

2. Exhibit A to Rule 15c3-3

The proposed amendment to Note G to Exhibit A to Rule 15c3-3 would potentially modify broker-dealers' existing practices to impose additional recordkeeping burdens. Currently, Note G to Exhibit A to Rule 15c3-3 allows a broker-dealer to include, as a debit in the formula for determining its reserve requirements, the amount of customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives organization that meets one of four standards, including maintaining the highest investment grade rating from an NRSRO.¹¹⁴ The proposed amendment would remove the standard of a registered clearing or derivatives organization that has the highest investment grade rating from an NRSRO as one of the four options a broker-dealer can look at prior to keeping customers' positions in security future products with such a firm. As such, the Commission believes that firms that previously relied on NRSRO ratings for the purposes of Note G would be required to use another method for assessing the creditworthiness of registered clearing or derivatives organizations. In addition, the expectation that the broker-dealer be able to explain that any such clearing or derivatives organizations it uses meet

¹¹² The Commission believes that the reviews required by the proposed amendments would be performed by an attorney at an average rate of \$354 per hour. Furthermore, the Commission believes that the review process will entail ten hours of initial work. 10 hours × \$354 = \$3,540 per firm. 158 broker-dealers × \$3,540 = \$599,320 aggregate industry cost. *SIFMA Report on Management and Professional Earnings in the Securities Industry 2010*.

¹¹³ See, e.g., *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, Exchange Act Release No. 49830 (Jun. 8, 2004), 69 FR 34428 at 34456 (Jun. 21, 2004).

¹¹⁴ A broker-dealer may also include customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives organization (1) that maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least \$2 billion, at least \$500 million of which must be in the form of security deposits; (2) that maintains at least \$3 billion in margin deposits; or (3) which does not meet any of the other criteria but which the Commission has agreed, upon a written request from the broker-dealer, that the broker-dealer may utilize. 17 CFR 240.15c3-3a, Note G, (b)(1)(i)-(iv).

the standard set forth in the proposed amendment would result in the creation and maintenance of records of those assessments. The Commission estimates that approximately 90 firms would be required to comply with the provisions of Note G.¹¹⁵ In the final release adding Note G to Exhibit A to Rule 15c3-3,¹¹⁶ the Commission estimated that under subparagraph (c) to Note G, each broker-dealer would spend approximately 0.25 hours to verify that the clearing organizations they used met the conditions of Note G. Using that same hours estimate, the Commission estimates an aggregate one-time total of 22.5 hours¹¹⁷ for broker-dealers to verify the status of a registered clearing or derivatives organization under the proposed amendment. The Commission believes that the proposed amendment would impose an additional one-time burden for broker-dealers that need to change how they evaluate the creditworthiness of a registered clearing or derivatives organization. Given the additional options set forth in Note G, the Commission estimates this would result in the broker-dealer spending, on average, one hour determining whether a clearing organization meets the remaining requirements of Note G,¹¹⁸ resulting in an aggregate initial burden of 90 hours.¹¹⁹ The Commission also estimates that firms would use a senior operations manager to review these standards. The Commission estimates the one-time costs of senior operations manager to be \$331 per-firm, resulting in an aggregate industry cost of \$29,790.¹²⁰

¹¹⁵ The number 90 comes from reviewing the members of the OCC listed in the member directory on the OCC's Web site (<http://www.optionsclearing.com/membership/member-information/>). Of the list of 231 members, the Commission looked only at those who trade in single stock futures. Of the list of members that trade in single stock futures, the Commission deleted any members who had the exact same firm name but different firm numbers.

¹¹⁶ See *Reserve Requirements for Margin Related to Security Futures Products*, Exchange Act Release No. 34-50295 (Aug. 31, 2004), 69 FR 54182 at 54188 (Sept. 7, 2004).

¹¹⁷ $0.25 \times 90 = 22.5$.

¹¹⁸ Currently the OCC is the only clearing agency registered with the Commission. The OCC maintains far more than \$3 billion in margin deposits, which is another way for a broker-dealer to verify a registered clearing agency or derivatives clearing organization under Note G. Thus, the Commission believes that any broker-dealer who is currently using NRSRO ratings to verify a registered clearing agency or derivatives clearing organization will be able to quickly verify the registered clearing agency or derivatives clearing organization using a different method.

¹¹⁹ $90 \text{ broker-dealers} \times 1 \text{ hour} = 90 \text{ hours}$.

¹²⁰ The Commission believes that the reviews required by the proposed amendments would be performed by a senior operations manager at an average rate of \$331 per hour. Furthermore, the

The Commission generally requests comment on all aspects of these proposed estimates. In addition, the Commission requests specific comment on the following items related to these estimates:

- Is the Commission correct in its estimate of the number of broker-dealers that would be affected by the proposed amendment to Note G?
- Is the Commission correct in its belief that broker-dealers would engage a senior operations manager to review their standards for verifying the status of a registered clearing agency or derivatives clearing organization? If not, how would firms review such standards and what would be the effect of such differing approaches on its burden estimates?

3. Regulation M

As discussed above, the proposed changes to Rules 101 and 102 of Regulation M would amend the exceptions for nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities in those rules. Under the proposed amendments, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to assess nonconvertible debt, nonconvertible preferred, and asset-backed securities to determine whether that security reasonably is liquid relative to the market for that asset class, trade based on yield, and fungible with securities with similar yields in order to rely on the exception. Further, distribution participants, issuers, selling shareholders, and affiliated purchasers of such persons would need to obtain an independent third-party to verify their analysis under the proposal. Persons seeking to rely on these proposed revised exceptions would need to demonstrate compliance with the proposed revised exceptions.

The Commission initially estimates that there are approximately 863 distributions of nonconvertible debt, nonconvertible preferred, and asset-backed securities, on average, annually that would be subject to the proposed revised exceptions. The Commission bases this estimate on the average number of offerings of investment grade nonconvertible debt, investment grade nonconvertible preferred, and investment grade asset-backed securities over the last three years.¹²¹ The

Commission believes that the review process will entail one hour of initial work. $\$331 \times 1 = \$331 \times 90 = \$29,790$. *SIFMA Report on Management and Professional Earnings in the Securities Industry 2010*.

¹²¹ Rules 101 and 102 only apply to distributions, not all offerings of securities. As a result, the

Commission believes that this is a reasonable estimate since it expects that the number of distributions eligible for the proposed revised exceptions should be similar to the number of distributions currently excepted under Rules 101(c)(2) and 102(d)(2).

The Commission initially estimates that the proposed revised exceptions would impose an average annual burden of 1 hour per distribution.¹²² This accounts for the internal time to obtain the information necessary to comply with the proposed revised exceptions and conduct analysis based on this information. Further, the Commission initially estimates that the proposed revised exceptions would impose an outside cost burden to retain an independent third party to verify the analysis by the person seeking to rely on the proposed revised exceptions, resulting in an estimated average annual burden of \$4,800¹²³ per distribution. Based on the total number of distributions estimated to be subject to the proposed revised exceptions (863), the Commission estimates that the total average annual burden is approximately 863 hours and \$4.1 million.

The collection of information would be necessary to obtain the benefit of the proposed revised exceptions. The proposed revised exceptions do not prescribe retention periods. All registered broker-dealers engaged in underwriting that would be subject to the proposed revised exceptions are currently required to retain records in accordance with Rules 17a-2 through 17a-4. The collection of information under the proposed revised exceptions would be provided to Commission and SRO examiners but would not be subject to public availability.

We specifically request comment on all aspects of these proposed estimates.

4. Rule 10b-10

The proposed amendment to Rule 10b-10 is not expected to change the

Commission discounted the actual average number of offerings of nonconvertible debt, investment grade nonconvertible preferred, and investment grade asset-backed securities over the last three years (1,151) by 25%.

¹²² We anticipate that the 1 hour would be spent by business analysts of the person seeking to rely on the proposed revised exceptions.

¹²³ We estimate that an outside management consultant would spend 8 hours and charge \$600 per hour to verify the analysis. The \$600 per hour figure is from the 75th percentile figure for a management consultant from <http://www.payscale.com>, adjusted for an 1800-hour work-year and multiplied by a 5.35 factor which is normally used to include benefits but here is used as an approximation to offset the fact that New York salaries are typically higher than the rest of the country. The result is \$596 per hour, which can be rounded to \$600 per hour. We request comment on this estimate.

cost of generating and sending confirmations, and, the Commission believes that broker-dealers may not need to incur significant costs if they choose not to input information that a debt security is unrated into their existing confirmation systems. Accordingly, the Commission does not believe the proposed amendment would result in any substantive change in a broker-dealer's record-keeping or reporting burdens.

5. Request for Comment

Pursuant to 44 U.S.C. 3306(c)(2)(B), the Commission requests comment on the proposed collections of information in order to: (1) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility; (2) evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; (4) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and (5) evaluate whether the proposed rule amendments would have any effects on any other collection of information not previously identified in this section.

Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, *Attention:* Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090, and refer to File No. S7-15-11. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this document in the **Federal Register**; therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-15-11, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE., Washington, DC 20549-0213.

V. Economic Analysis

As discussed above, the Dodd-Frank Act requires that the Commission and other federal agencies replace references to credit ratings in all of its regulations with a standard of creditworthiness that the Commission deems appropriate. The proposed amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, Rules 101 and 102 of Regulation M, and Rule 10b-10 would accomplish this task by eliminating the reference to and requirement for the use of NRSRO ratings in these rules. The Commission recognizes that there are additional external costs associated with the adoption of the proposed amendments that are separate from the hour burdens discussed in the Paperwork Reduction Act. Thus, the Commission has identified certain costs and benefits of the proposed rule amendments and requests comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in the analysis.¹²⁴

The Commission seeks comment and data on the value of the benefits identified. The Commission also seeks comments on the accuracy of its cost estimates in each section of this cost-benefit analysis, and requests those commenters to provide data, including identification of statistics relied on by commenters to reach conclusions on cost estimates. Finally, the Commission seeks estimates and views regarding these costs and benefits for particular types of market participants, as well as any other costs or benefits that may result from these proposed rule amendments.

Under Section 3(f) of the Exchange Act,¹²⁵ the Commission shall, when engaging in rulemaking that requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act¹²⁶ requires the Commission to consider the competitive effects of any rules the Commission adopts under the Exchange Act. Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the

purposes of the Exchange Act. The Commission's preliminary view, as discussed in greater detail with respect to each proposed amendment below, is that any potential burden on efficiency, competition, and capital formation resulting from the proposed rules would be consistent with the intent of Congress as expressed by the Dodd-Frank Act.

A. Rule 15c3-1 and Rule 17a-4

1. Benefits

The Commission anticipates that one of the primary benefits of the proposed amendments, if adopted, would be the benefit to broker-dealers of reducing their possible undue reliance on NRSRO ratings that could be caused by references to NRSROs in its rules. The rule amendments could encourage broker-dealers to examine more than a single source of information, such as a rating, when analyzing the creditworthiness of a financial instrument. Significantly, the Commission believes that eliminating the reliance on NRSRO ratings in its rules would remove any appearance that the Commission has placed its imprimatur on such ratings. The Commission, however, also recognizes that credit ratings may provide useful information to institutional and retail investors as part of the process of making an investment decision.

The Commission preliminarily believes that the proposed amendments to the Net Capital Rule and its appendices, as well as the conforming amendment to Rule 17a-4, could result in a better overall assessment of the risks associated with securities held by broker-dealers for the purposes of net capital calculations as well as of the long-term financial strength and general creditworthiness of clearing organizations to which customers' positions in security futures products are posted. As the NRSROs themselves have stressed, the ratings they generate focus solely on credit risk, that is, the likelihood that an obligor or financial obligation will repay investors in accordance with the terms on which they made their investment.¹²⁷ Many broker-dealers already conduct their own risk evaluation. However, for those broker-dealers that do not, developing

¹²⁷ See, e.g., *Inside the Ratings: What Credit Ratings Mean*, Fitch, Aug. 2007 ("Inside the Ratings"), p. 1; Testimony of Michael Kanef, Group Managing Director, Moody's Investors Service, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), p. 2; Testimony of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), p. 3.

¹²⁴ SIFMA Report on Management and Professional Earnings in the Securities Industry 2010.

¹²⁵ 15 U.S.C. 78c(f).

¹²⁶ 15 U.S.C. 78w(a)(2).

their own means of evaluating risk—including, as would be required by the proposed amendments to the Net Capital Rule, an evaluation of the degree of liquidity—should allow them to better incorporate the overall levels of various categories of risk associated with the securities they hold for their net capital calculations and lead to a better understanding of the risks associated with those securities. The Commission believes that for those broker-dealers that do not currently have their own means of evaluating risk for purposes of the Net Capital Rule, the approach outlined in this release is the best option, outside of using NRSRO ratings, for a broker-dealer to evaluate the risks associated with those securities.

2. Costs

The Commission anticipates that broker-dealers could incur additional costs if the proposed amendments are adopted because of the costs associated with performing a more detailed and comprehensive analysis of the debt securities. These costs could include establishing, reviewing, and adjusting the various policies and procedures needed for a comprehensive analysis of the debt securities. There also could be costs associated with applying and implementing these adjusted procedures.

The Commission believes that the costs of compliance with the proposed amendments to the Net Capital Rule and its appendices, as well as the conforming amendment to Rule 17a-4, would be minimal for those entities that already employ their own criteria in determining credit risk for net capital purposes. Of the approximately 480 broker-dealers that hold proprietary debt positions, the Commission recognizes that the level of sophistication varies widely. The institutions with less sophisticated internal procedures for analyzing credit risk may incur costs to establish and develop procedures that would be used to assess financial instruments for the purposes of determining whether the lower haircuts could appropriately be applied.

In the event the broker-dealer inaccurately evaluates the creditworthiness and liquidity of its positions, a potential cost could be that the broker-dealer is required to take a larger haircut on its proprietary positions, and, therefore, reserve additional capital. This could affect its ability to hold its positions or to add to its positions. In addition, the proposed rule could potentially affect the ability of issuers of commercial paper,

nonconvertible debt, and preferred stock to raise capital if broker-dealers change their investment decisions for their proprietary accounts as a result of potential costs or other aspects of the proposed amendments.

Some broker-dealers may determine a security qualifies for a reduced haircut when it would not have qualified under the current NRSRO standard. This could have a potential impact on the firm's ability, if it experiences financial difficulties, to be in a position to meet all obligations to customers, investors, and other counterparties and generate resources to wind-down its operations in an orderly manner without the need of a formal proceeding, with attendant costs.

In addition, those broker-dealers whose internal evaluations differ from the ratings may have extra costs during examinations to prove to the regulators the accuracy of their internal evaluations. Those broker-dealers that do not have their own criteria for determining credit risk for net capital purposes will have larger start up costs than other broker-dealers. However, the Commission believes that firms that hold a small number of securities for net capital purposes may do an internal cost benefit analysis and decide to take the 15% haircut instead of creating an internal credit risk evaluation process if the costs of creating such an evaluation process are too high. To the extent that broker-dealers decide to take the 15% haircut instead of creating an internal credit risk evaluation process, it is possible that those broker-dealers may maintain more net capital than would be required by the Net Capital Rule.

For firms that use Appendix A to Rule 15c3-1, the Commission preliminarily believes there will be minimal costs associated with the proposed amendments. The proposed amendments to the definition of "major market foreign currency" will not change what foreign currencies meet the definition; it will only change the wording of the definition. Therefore, the Commission does not believe there will be any additional costs associated with the proposed amendments.

As for the firms that use Appendix E and F to Rule 15c3-1, these firms are already using internal ratings scales to determine credit risks for each counterparty. Any new firms that apply to use either Appendix E or Appendix F will not incur any additional costs as a result of the proposed amendments. Currently, firms that apply to use these appendices must have their internal models approved by the Commission prior to using their selected appendix. Although the Commission will have to

assign a ratings scale to the output of the internal models during the approval process, the Commission does not believe this step will cause broker-dealers or OTC derivatives dealers who are applying to use these appendices to incur any additional costs. Furthermore, because these firms have traditionally used models, as opposed to NRSRO ratings, to compute capital charges, the Commission does not believe these firms will incur any additional costs by complying with the proposed amendments.

B. Exhibit A to Rule 15c3-3

1. Benefits

The Commission believes that eliminating the reliance on NRSRO ratings in its rules would remove any appearance that the Commission has placed its imprimatur on such ratings. The Commission preliminarily believes that the proposed amendments to Note G to Exhibit A to Rule 15c3-3 would serve to promote efficiency and capital formation. As noted above, the Commission believes that broker-dealers will develop their own means of evaluating the long-term financial strength and general creditworthiness of clearing organizations to which customers' positions in security futures products are posted for purposes of Note G to Exhibit A to Rule 15c3-3. These broker-dealers would be better positioned to incorporate the overall levels of various categories of risk associated with those organizations into their assessments, creating a more efficient means of evaluating those organizations for the sake of the Customer Protection Rule, rather than simply relying on NRSRO credit ratings alone. As the NRSROs themselves have stressed, the ratings they generate focus solely on credit risk, that is, the likelihood that an obligor or financial obligation will repay investors in accordance with the terms on which they made their investment.¹²⁸ The Commission does not anticipate that the proposed amendments to Note G to Exhibit A to Rule 15c3-3 would have any impact on competition.

¹²⁸ See, e.g., *Inside the Ratings: What Credit Ratings Mean*, Fitch, Aug. 2007 ("Inside the Ratings"), p. 1; Testimony of Michael Kanef, Group Managing Director, Moody's Investors Service, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), p. 2; Testimony of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), p. 3.

2. Costs

The Commission believes that the costs of compliance with Note G to Exhibit A to Rule 15c3-3 would be minimal because the amendment would simply eliminate one factor a broker-dealer can use to evaluate a clearing organization. The Commission believes that the removal of one of these four means of complying with section (b)(1) of Note G will not adversely affect the purpose of this section; namely to ensure that a broker or dealer has the margin related to security futures products on deposit only with qualified registered clearing agencies or derivatives clearing organizations. As stated in the Paperwork Reduction Act section, the Commission anticipates that a broker-dealer will incur a one-time cost and an annual cost to verify that a clearing organization or derivatives clearing organization meets the requirements of Note G. If a broker-dealer is currently using a verification process other than the use of NRSRO ratings, that broker-dealer will not incur any one-time costs.

C. Rules 101 and 102 of Regulation M

The purpose of the proposed revised exceptions from Rules 101 and 102 of Regulation M for nonconvertible debt, nonconvertible preferred, and asset-backed securities is to address Section 939A of the Dodd-Frank Act as well as place the emphasis of the exception on the trading aspects of the securities by those bringing it to market, ensuring that the exception is utilized in reference to securities that are less likely to be subject to manipulation.

The Commission preliminarily believes that the proposed amendments to Rules 101 and 102 of Regulation M are intended to promote capital formation. The proposed amendments should promote continued investor trust in the offering process by proposing an exception from Regulation M's Rule 101 and 102 prohibitions limited to those securities which are less vulnerable to manipulation. Such investor trust in our markets should promote continued capital formation. The Commission believes that the proposals should foster continued market integrity which should also translate into capital formation by only allowing for non-manipulative buying activity during distributions. Issuers of nonconvertible debt, nonconvertible preferred securities and asset-backed securities who fall within the proposed exceptions may be encouraged to engage in capital formation knowing that the proposed exceptions are available for their buying activity as well as the buying activity of

distribution participants. For these reasons, the Commission preliminarily believes that the proposed exceptions will promote efficient capital formation and competition.

The Commission has considered the proposed amendments to Rules 101 and 102 of Regulation M in light of the standards cited in Section 23(a)(2) and believes preliminarily that, if adopted, they would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act. The proposals would apply equally to all distribution participants, issuers, selling shareholders, and affiliated purchasers. Thus, no person covered by Regulation M should be put at a competitive disadvantage and the proposal would not impose a significant burden on competition not necessary or appropriate in furtherance of the Act.

1. Benefits

The proposed revised exceptions should continue to promote investor trust in the offering process and the market as a whole by excepting only those nonconvertible debt, nonconvertible preferred, and asset-backed securities that are less vulnerable to manipulation. Market integrity would also continue to be promoted, which benefits the market and all participants.

2. Costs

The Commission expects the costs of the proposal to modify Rules 101 and 102 of Regulation M to be minimal to most persons subject to those rules. The Commission expects the number of instances in which the proposed revised exceptions would be triggered to be limited. The proposed revised exceptions would only be triggered when there is an offering of nonconvertible debt, nonconvertible preferred, or asset-backed securities that qualifies as a distribution under Regulation M where a distribution participant, issuer, selling shareholder, or affiliated purchaser bids for, purchases, or attempts to induce another person to bid for or purchase the covered security during the applicable restricted period. As there may be offerings of nonconvertible debt, nonconvertible preferred, and asset-backed securities that do not constitute a distribution for purposes of Regulation M, the prohibitions of Rules 101 and 102 of Regulation M would not be triggered and, thus, the need for reliance upon either the current or proposed revised exceptions would not be necessary. Additionally, even if a distribution of the nonconvertible debt,

nonconvertible preferred, or asset-backed securities exists, a person subject to the prohibitions of Rules 101 or 102 of Regulation M could structure buying activity before or after the applicable restricted period so as not to incur any costs, even if minimal, associated with relying on the proposed revised exceptions.

When the proposed revised exceptions would be used, however, the Commission believes that there would be increased costs for distribution participants, issuers, selling shareholders, and affiliated purchasers under the proposed revised exceptions compared to the expected costs under the current exceptions in Rules 101(c)(2) and 102(d)(2). Distribution participants, issuers, selling shareholders, and affiliated purchasers would need to reasonably determine whether a security is liquid relative to the market for that asset class, trades in relation to general market interest rates and yield spreads, and is relatively fungible with securities of similar characteristics and interest rate yield spreads in order to rely on the exception. This determination would require the distribution participant, issuer, selling shareholder, or affiliated purchaser to train staff and devote manpower and other resources towards making this assessment when relying on the proposed revised exceptions. As detailed in the PRA section above, the Commission preliminarily estimates total annual ongoing internal costs of approximately \$167,422 for distribution participants, issuers, selling shareholders, and affiliated purchasers seeking to rely on the exception.¹²⁹

Further, distribution participants, issuers, selling shareholders, and affiliated purchasers would need to obtain an independent third party to verify this initial assessment. This process would create new costs to be borne by distribution participants, issuers, selling shareholders, and affiliated purchasers when relying on the proposed revised exceptions to hire such a party and review this verification. Distribution participants, issuers, selling shareholders, and affiliated purchasers seeking an independent third party verification that the issue meets the criteria required to obtain the proposed exceptions may find that the price of the independent

¹²⁹ This figure was calculated as follows (1 business analyst hours × \$194) = \$194 per response × 863 responses = \$167,422 total cost for all respondents. The Commission estimates that the average hourly rate for an intermediate business analyst in the securities industry is approximately \$194 per hour. *SIFMA Report on Management and Professional Earnings in the Securities Industry 2010*.

third party verification could potentially lead to other economic effects. These effects could include, for instance, the potential for the verifier to be liable for claims if the exception is disputed after it has been relied upon. While difficult to quantify, the Commission preliminarily estimates that it is possible for the verifier's potential liability to be a significant multiple of the compliance-hours-cost-estimate provided for PRA purposes, and will depend upon the perceived risk in asserting that the security is liquid relative to the market for that asset class, trades in relation to general market interest rates and yield spreads, and is relatively fungible with securities of similar characteristics and interest rate yield spreads. These are new costs not currently borne by distribution participants, issuers, selling shareholders, or their affiliated purchasers. If potential liability leads to increased costs in obtaining an independent third party, some persons who currently rely on the exception may determine that it is no longer cost effective to qualify for the exception. This may have the effect of limiting the instances in which the exception is utilized, which in turn may expand the scope of the restrictions of Rules 101 and 102 of Regulation M. Thus, the increase in costs resulting from the third party verification may, in effect, narrow the exceptions for those who currently rely on them.

The Commission also expects that there could be a small number of securities taken out of this exception as a result of the proposed change. Costs for issuers, selling shareholders, underwriters, brokers, dealers, any other distribution participants, or affiliated purchasers of any of these persons affected by this change would be more significant in that these persons may now be required to comply with Rule 101 or 102 of Regulation M where they did not have to before. As a result of this change, these affected parties and their affiliated purchasers would be prohibited from bidding for, purchasing, or attempting to induce any person to bid for or purchase the covered security during the restricted period. However, the Commission does not expect there to be a significant number of these persons. Further, these persons may be able to rely on a different exception from Rule 101 or 102 depending on the circumstances.

D. Rule 10b-10

1. Benefits

The proposed amendments to Rule 10b-10 eliminate a requirement for

transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. The other requirements of Rule 10b-10 would remain unchanged. Eliminating this requirement would avoid giving credit ratings an imprimatur that may inadvertently suggest to investors that an unrated security is inherently riskier than a rated security. Accordingly, the Commission anticipates that investors and the marketplace would benefit from the elimination of this requirement, in light of concerns about promoting over-reliance on securities ratings or creating confusion about the significance of those ratings. More generally, eliminating this requirement is consistent with the goal of promoting a dialogue between broker-dealers and their customers—prior to purchase—regarding the creditworthiness of issuers, and should help avoid promoting the use of credit ratings as an oversimplified shorthand that replaces a more complete discussion of credit quality issues.

2. Costs

The Commission does not expect the proposed amendment to result in any significant changes in the costs associated with Rule 10b-10. Broker-dealers will continue to generate transaction confirmations and send those confirmations to customers, and the proposed amendment, if adopted, would not be expected to change the cost of generating and sending confirmations. Moreover, the Commission believes that broker-dealers may not need to incur significant costs if they choose not to input information that a debt security is unrated into their existing confirmation systems.

E. Request for Comment on Economic Analysis

The Commission requests data to quantify the costs and the benefits above. The Commission seeks estimates of these costs and benefits, as well as any costs and benefits not already described, which could result from the adoption of the proposed amendments.

- The Commission seeks specific comments on the economic analysis outlined above with respect to Rule 15c3-1, its Appendices and Rule 17a-4. Are there any additional costs associated with these proposed amendments that were not factored into the above analysis? Commenters should provide specific examples of cost estimates.

- The Commission seeks specific comments on the economic analysis outlined above with regard to Exhibit A

to Rule 15c3-3. Are there any additional costs associated with the proposed amendment that were not factored into the above analysis? Commenters should provide specific examples of cost estimates.

- The Commission seeks specific comments on the economic analysis outlined above with regard to the proposed revised exceptions to Rules 101 and 102 of Regulation M. What new costs would the proposed revised exceptions create for those seeking to rely on them? Are there any costs not already accounted for in this proposal created by the proposed revised exceptions?

- The Commission seeks specific comments on the economic analysis outlined above with regard to the Rule 10b-10. Are there any additional costs associated with this proposal that were not factored into the above analysis? Commenters should provide specific examples of cost estimates.

VI. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (“SBREFA”), the Commission must advise OMB as to whether the proposed regulation constitutes a “major” rule. Under SBREFA, a rule is considered “major” where, if adopted, it results or is likely to result in: (1) An annual effect on the economy of \$100 million or more (either in the form of an increase or decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. If a rule is “major,” its effectiveness will generally be delayed for 60 days pending Congressional review.

The Commission requests comment on the potential impact of the proposed rules and form on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

VII. Initial Regulatory Flexibility Analysis

Section 3(a) of the Regulatory Flexibility Act of 1980¹³⁰ requires the Commission to undertake an initial regulatory flexibility analysis of the proposed rule on small entities unless the Commission certifies that the rule, if adopted, would not have a significant economic impact on a substantial

¹³⁰ 5 U.S.C. 603(a).

number of small entities.¹³¹ Pursuant to Section 605(b) of the Regulatory Flexibility Act (“RFA”), the Commission hereby certifies that the proposed amendments to the rule, would not, if adopted, have a significant economic impact on a substantial number of small entities.

For purposes of Commission rulemaking in connection with the RFA, small entities include broker-dealers with total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act,¹³² or, if not required to file such statements, a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.¹³³

The proposed amendments to the securities haircut provisions in paragraphs (E), (F), and (H) of Rules 15c3-1(c)(2)(vi) and the conforming amendment to Rule 17a-4, if adopted, would not have a significant economic impact on a small number of entities. The Commission preliminarily believes that a broker-dealer with less than \$500,000 in total capital holds very few positions and, in particular, a small number of debt securities. Thus, the Commission preliminarily believes that there are few small entities that will be subject to these new rules. In addition, if there are small broker-dealers that hold these debt positions, they are already required to examine the risk associated with their debt securities when taking haircuts on these securities. The proposed amendments could alter this process but it would not be a new process that the small broker-dealer would have to comply with. Accordingly, the rule would not have any significant economic impact on small entities because even if they have to change their current process, they are still required to examine the risk associated with their debt securities.

The proposed amendment to Appendix A to Rule 15c3-1 will not be a burden to small entities. Although the definition of major market foreign currency will change, the currencies that meet the definition will not change.

The proposed amendments to the Appendices E and F to Rule 15c3-1

(which include conforming amendments to Appendix G to Rule 15c3-1 and the General Instructions to Form X-17A-5, Part IIB), if adopted, would not apply to small entities. Appendices E and G apply to broker-dealers that are part of a consolidated supervised entity and Appendix F and Form X-17A-5, Part IIB apply to OTC Derivatives Dealers that have applied to the Commission for authorization to compute capital charges as set forth in Appendix F in lieu of computing securities haircuts pursuant to Rule 15c3-1(c)(2)(vi). All of these brokers or dealers would be larger than the definition of a small broker dealer in Rule 0-10.

The proposed amendments to Exhibit A to Rule 15c3-3, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposed amendments to Exhibit A to Rule 15c3-3 would apply only to broker-dealers that clear and carry positions in security futures products in securities accounts for the benefit of customers. None of those broker-dealers affected by the rule is a small entity as defined in Rule 0-10.¹³⁴

With respect to the amendments to Rules 101 and 102 of Regulation M, it is unlikely that any broker-dealer that is defined as a “small business” or “small organization” as defined in Rule 0-10 could be an underwriter or other distribution participant as they would not have sufficient capital to participate in underwriting activities. Small business or small organization for purposes of “issuers” or “person” other than an investment company is defined as a person who, on the last day of its most recent fiscal year, had total assets of \$5 million or less. The Commission believes that none of the various persons that would be affected by this proposal would qualify as a small entity under this definition as it is unlikely that any issuer of that size had investment grade securities that could rely on the existing exception. Therefore, the Commission believes that these amendments would not impose a significant economic impact on a substantial number of small entities.

The Commission believes that the proposed amendment to Rule 10b-10 will not have a significant economic impact on a substantial number of small entities. While some broker-dealers that effect transactions in the debt securities currently subject to paragraph (a)(8) of that rule may be small entities, the

proposed amendment should not result in any significant change to the cost of providing confirmations to customers in connection with those transactions.

The Commission encourages written comments regarding this certification. The Commission solicits comment as to whether the proposed amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, Rules 101 and 102 of Regulation M, and Rule 10b-10, could have an effect on small entities that has not been considered. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

VIII. Statutory Basis and Text of the Proposed Amendments

Pursuant to the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly, Sections 3(b), 15, 23(a), and 36 (15 U.S.C. 78c(b), 78o, 78w(a), and 78mm), thereof, and Sections 939 and 939A of the Dodd-Frank Act, the Commission is proposing to amend §§ 240.10b-10, 240.15c3-1, 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g, 240.15c3-3a, 240.17a-4, 242.101, 242.102, and Form X-17A-5 Part IIB General Instructions under the Exchange Act.

List of Subjects in 17 CFR Parts 240, 242, and 249

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

Text of Amendment

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 is amended by adding sectional authorities for §§ 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g and for § 240.15c3-3a in numerical order, and by revising the sectional authorities for §§ 240.10b-10, 240.15c3-1, and 240.17a-4.

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; 18 U.S.C. 1350 and 12 U.S.C. 5221(e)(3), unless otherwise noted.

* * * * *

¹³¹ 5 U.S.C. 605(b).

¹³² See 17 CFR 240.17a-5(d).

¹³³ See 17 CFR 240.0-10(c).

¹³⁴ The main clearing organization, the OCC, requires its members to have total capital of \$2.5 million, far above the \$500,000 total capital threshold for a small business in Rule 0-10.

Section 240.10b-10 is also issued under secs. 2, 3, 9, 10, 11, 11A, 15, 17, 23, 48 Stat. 891, 89 Stat. 97, 121, 137, 156, (15 U.S.C. 78b, 78c, 78i, 78j, 78k, 78k-1, 78o, 78q) and Pub. L. No. 111-203, secs. 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o-7 note).

* * * * *

Section 240.15c3-1 is also issued under secs. 15(c)(3), 15 U.S.C. 78o(c)(3) and Pub. L. No. 111-203, secs. 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o-7 note).

Sections 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g are also issued under Pub. L. No. 111-203, §§ 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o-7 note).

* * * * *

Section 240.15c3-3a is also issued under Pub. L. No. 111-203, §§ 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o-7 note).

* * * * *

Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w); and Pub. L. No. 111-203, secs. 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o-7 note)

§ 240.10b-10 [Amended]

2. Section 240.10b-10 is amended by removing paragraph (a)(8) and redesignating paragraph (a)(9) as paragraph (a)(8).

3. Section 240.15c3-1 is amended by revising paragraphs (c)(2)(vi)(E) introductory text, (c)(2)(vi)(F)(1) introductory text, (c)(2)(vi)(F)(2) introductory text, and (c)(2)(vi)(H).

The revisions read as follows:

§ 240.15c3-1 Net capital requirements for brokers or dealers.

* * * * *

(c) * * *

(2) * * *

(vi) * * *

(E) *Commercial paper, bankers acceptances and certificates of deposit.* In the case of any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited, and has only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, or in the case of any negotiable certificates of deposit or bankers acceptance or similar type of instrument issued or guaranteed by any bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, the

applicable percentage of the market value of the greater of the long or short position in each of the categories specified below are:

* * * * *

(F)(1) *Nonconvertible debt securities.* In the case of nonconvertible debt securities having a fixed interest rate and a fixed maturity date, which are not traded flat or in default as to principal or interest and which have only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

* * * * *

(2) A broker or dealer may elect to exclude from the above categories long or short positions that are hedged with short or long positions in securities issued by the United States or any agency thereof or nonconvertible debt securities having a fixed interest rate and a fixed maturity date and which are not traded flat or in default as to principal or interest, and which have only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, if such securities have maturity dates:

* * * * *

(H) In the case of cumulative, non-convertible preferred stock ranking prior to all other classes of stock of the same issuer, which has only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, and which are not in arrears as to dividends, the deduction shall be 10% of the market value of the greater of the long or short position.

* * * * *

§ 240.15c3-1a [Amended]

4. Section 240.15c3-1a is amended by removing the phrase “whose short term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and” and removing the sentence “For purposes of this section, the European Currency Unit (ECU) shall be deemed a major market foreign currency.” from paragraph (b)(1)(i)(C).

5. Section 240.15c3-1e is amended by:

a. Revising the introductory text in paragraph (c)(4)(vi);

b. Removing paragraphs (c)(4)(vi)(A) through (c)(4)(iv)(D);

c. Redesignating paragraphs (c)(4)(vi)(E), (F), and (G) as paragraphs (c)(4)(vi)(A), (B), and (C), respectively; and

d. Revising newly redesignated paragraph (c)(4)(vi)(A).

The revisions read as follows:

§ 240.15c3-1e Deductions for market and credit risk for certain brokers or dealers (Appendix E to 17 CFR 240.15c3-1).

* * * * *

(c) * * *

(4) * * *

(vi) *Credit risk weights of counterparties.* A broker or dealer that computes its deductions for credit risk pursuant to this Appendix E shall apply a credit risk weight for transactions with a counterparty of either 20%, 50%, or 150% based on an internal credit rating the broker or dealer determines for the counterparty.

(A) As part of its initial application or in an amendment, the broker or dealer may request Commission approval to apply a credit risk weight of either 20%, 50%, or 150% based on internal calculations of credit ratings, including internal estimates of the maturity adjustment. Based on the strength of the broker’s or dealer’s internal credit risk management system, the Commission may approve the application. The broker or dealer must make and keep current a record of the basis for the credit rating of each counterparty;

* * * * *

6. Section 240.15c3-1f is amended by:

a. Removing the phrase from paragraph (d)(2), “the counterparty factor. The counter party factors are:” and adding in its place “a counterparty factor of 20%, 50%, or 100% based on an internal credit rating the OTC derivatives dealer determines for the counterparty.”; and

b. Revising paragraphs (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4).

The revisions read as follows:

§ 240.15c3-1f Optional market and credit risk requirements for OTC derivatives dealers (Appendix F to 17 CFR 240.15c3-1).

* * * * *

(d) * * *

(3) * * *

(i) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt or commercial paper that would apply a 20% counterparty factor under (d)(2)(i) of this section, 5% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer’s tentative net capital;

(ii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 50% counterparty factor under (d)(2)(ii) of this section, 20% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(iii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 100% counterparty factor under (d)(2)(iii) of this section, 50% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital.

(4) Counterparties may be rated by the OTC derivatives dealer, or by an affiliated bank or affiliated broker-dealer of the OTC derivatives dealer, upon approval by the Commission on application by the OTC derivatives dealer. Based on the strength of the OTC derivatives dealer's internal credit risk management system, the Commission may approve the application. The OTC derivatives dealer must make and keep current a record of the basis for the credit rating for each counterparty.

* * * * *

§ Section 240.15c3-1g [Amended]

7. Section 240.15c3-1g(a)(3)(i)(F) is amended by removing the phrase "paragraphs (c)(4)(vi)(D) and (c)(4)(vi)(E)" and adding in its place "paragraph (c)(4)(vi)(A) and paragraph (c)(4)(vi)(B)".

§ 240.15c3-3a [Amended]

8. Section 240.15c3-3a is amended by removing paragraph (b)(1)(i) of Note G and redesignating paragraphs (b)(1)(ii), (iii), and (iv) as paragraphs (b)(1)(i), (ii), and (iii), respectively.

9. Section 240.17a-4 is amended by:

a. Removing the phrase from paragraph (b)(12), "§ 240.15c3-1e(c)(4)(vi)(D) and (E)" and adding in its place "§ 240.15c3-1e(c)(4)(vi)"; and

b. Adding paragraph (b)(13).

The addition reads as follows:

§ 240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.

* * * * *

(b) * * *

(13) The written policies and procedures the broker-dealer establishes, maintains, and enforces to assess creditworthiness for the purpose of § 240.15c3-1(c)(2)(vi)(E), (F)(1), (F)(2), and (H).

* * * * *

PART 242—REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

10. The general authority citation for Part 242 is revised and the following citations are added in numerical order to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, 80a-37, unless otherwise noted.

* * * * *

Sections 242.101 and 242.102 are also issued under Pub. L. No. 111-203, §§ 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o-7 note).

* * * * *

11. Section 242.101 is amended by revising paragraph (c)(2) to read as follows:

§ 242.101 Activities by distribution participants.

* * * * *

(c) * * *

(2) *Certain nonconvertible and asset-backed securities.* Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that are determined and demonstrated by the distribution participant or affiliated purchaser, and verified by an independent third party, utilizing reasonable factors of evaluation to:

(i) Be liquid relative to the market for that asset class;

(ii) Trade in relation to general market interest rates and yield spreads; and

(iii) Be relatively fungible with securities of similar characteristics and interest rate yield spreads; or

* * * * *

12. Section 242.102 is amended by revising paragraph (d)(2) to read as follows:

§ 242.102 Activities by issuers and selling security holders during a distribution.

* * * * *

(d) * * *

(2) *Certain nonconvertible and asset-backed securities.* Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that are determined and demonstrated by the issuer, selling security holder, or affiliated purchaser, and verified by an independent third party, utilizing reasonable factors of evaluation to:

(i) Be liquid relative to the market for that asset class;

(ii) Trade in relation to general market interest rates and yield spreads; and

(iii) Be relatively fungible with securities of similar characteristics and interest rate yield spreads; or

* * * * *

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

13. The authority citation for Part 249 is amended by adding the following citation in numerical order to read as follows:

Authority: 15 U.S.C. 78a *et seq.*, 7201 *et seq.*, 18 U.S.C. 1350, unless otherwise noted.

Section 249.617 is also issued under Pub. L. 111-203, §§ 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o-7 note).

* * * * *

14. Amend Form X-17A-5 Part IIB General Instructions (referenced in § 249.617) by:

a. Removing Schedule IV: Internal Credit Rating Conversion; and

b. Removing all but the first sentence in the section "Credit risk exposure" under the heading "Computation of Net Capital and Required Net Capital," and adding a second sentence that reads "The counterparty charge is computed using the credit risk weights assigned to the OTC derivatives dealer's internal calculations by the Commission under paragraph (d)(2) of Appendix F."

Note: The text of Form X-17A-5 Part IIB does not, and this amendment will not, appear in the Code of Federal Regulations

* * * * *

Dated: April 27, 2011.

By the Commission.

Elizabeth M. Murphy,
Secretary.

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