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SEC Proposes Revisions to Remove Credit Ratings from Regulation M, Broker-Dealer Net Capital Rule, Other Exchange Act Rules

In the third of a series of related rule proposals required by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), the Securities and Exchange Commission (the "SEC") has proposed revisions to Regulation M (the SEC's anti-market manipulation rule), the broker-dealer net capital rule and several other rules under the Securities Exchange Act of 1934 (the "Exchange Act") to remove references to credit ratings.

The SEC had proposed amending its rules and forms to remove references to credit ratings even before Dodd-Frank, most recently beginning in 2008. That proposal was prompted by perceptions that over-reliance on credit ratings by market participants had contributed to the financial crisis and concern that the use of ratings in SEC rules and forms appeared to give them an official imprimatur.

The comments on the 2008 proposal generally urged the SEC to retain many of the references to credit ratings in its rules and forms as useful and appropriate. In September 2009, the SEC adopted a small number of its proposed rule amendments and sought further comments on the more controversial of its 2008 proposals, including those affecting Regulation M, the broker-dealer net capital rule, and eligibility for short-form securities registration and shelf offerings. Once more, the comments generally opposed the proposed changes, and the SEC did not take further action.

Dodd-Frank became law in July of 2010. Section 939A of Dodd-Frank requires each Federal agency to review its regulations and "remove any reference to or requirement of reliance on credit ratings" and substitute alternative standards of credit-worthiness. Stripped of the discretion to leave ratings references in rules where they were deemed to serve a useful purpose, in February of this year the SEC proposed the first set of required revisions to remove credit rating references. That proposal dealt with rating references in a handful of rules and forms under the Securities Act of 1933 (the "Securities Act") and the Exchange Act, including the requirements to qualify for short-form registration of securities offerings on Forms S-3 and F-3.[1] In March of this year, the SEC proposed a second set of revisions,

[1] See our Alert Memo dated February 25, 2011, "SEC Proposes Revisions to Remove Credit Ratings from Certain Securities Act and Exchange Act Rules and Forms".

to remove credit rating references from rules and forms under the Investment Company Act of 1940, including Rule 2a-7, which prescribes limitations on investments by registered money market funds. The current proposal concerns revisions to several rules under the Exchange Act, including Regulation M and the broker-dealer net capital rule (Rule 15c3-1). The proposal also requests comments on the standard the SEC should propose to replace two statutory references to credit ratings that were removed from the Exchange Act definitions of "mortgage related security" and "small business related security" by Dodd-Frank.

In each of its three proposals, the SEC has indicated that its goal is to implement Dodd-Frank's requirements without necessarily changing the substantive results under the various rules and forms or imposing undue additional burdens on market participants. As they had with the previous proposals, the SEC is requesting suggestions for alternative formulations that would minimize the adverse effects of removing ratings references. The comment period for the most recent set of proposed changes will close on July 5, 2011.

Although this appears to be the final set of revisions Dodd-Frank requires to be made to the SEC's rules, the SEC has not indicated how it will address the use of credit ratings in SEC orders[2] or other less formal guidance (e.g. no-action letters) from the SEC or its staff.

Rules Proposed to be Changed

The credit rating references that this proposal seeks to modify are as follows:

- *Market Manipulation Rules*. Regulation M generally prohibits issuers, selling security holders and distribution participants such as underwriters from purchasing securities that are the subject of a distribution while that distribution is underway. Rules 101 and 102 of Regulation M exempt investment grade non-convertible debt and preferred stock and investment grade asset-backed securities from that prohibition. That exemption is based on the premise that those securities trade primarily on the basis of yield spread and credit rating and so it is virtually impossible to manipulate the market price of a single issue. In 2008 the SEC had proposed to modify these rules to instead exempt debt and preferred stock of well-known seasoned issuers ("WKSIs") and asset-backed securities registered on Form S-3. The proposing release for the current proposal notes the unanimous objection to that proposal, partly because it would have subjected a number of issues and issuers to Regulation M that had previously been exempt, which was not the SEC's intent. Accordingly, in the current proposal the SEC has changed its approach and is instead proposing to try to identify the characteristics of securities that make their markets difficult to manipulate. The new proposed approach would exempt nonconvertible debt and preferred stock and asset-backed securities from Regulation M if they:

[2] E.g., SEC Release No. 34-47683 (Apr. 16, 2003) (authorizing broker-dealers to pledge highly rated foreign sovereign or non-governmental debt as collateral for securities borrowings from customers).

- Are liquid relative to the market for that asset class (as indicated by such things as daily trading volume and number of market makers);

- Trade in relation to general market interest rates and yield spreads (rather than in relation to issuer-specific factors); and

- Are relatively fungible with securities of similar characteristics and interest rate yield spreads (for trading purposes).

The determination of whether these factors are met would be required to be made using reasonable factors of evaluation and then verified by an independent third party, which could not be counsel to the underwriter or issuer or an affiliate of theirs. The SEC requests comment on what the qualifications of such a third party should be, and whether for example an entity eligible to be a "qualified independent underwriter" in the distribution should be required.

- *Broker-Dealer Net Capital.* Exchange Act Rule 15c3-1 prescribes the minimum levels of net capital that securities broker-dealers must maintain. Net capital is generally defined as the broker-dealer's net worth, subject to a list of adjustments that include varying "haircuts," or deductions, from the value of securities held by the broker-dealer based upon factors that include the securities' type, maturity and, in the case of commercial paper, nonconvertible debt securities and preferred stock, their rating. If those securities are rated in the top three rating categories by at least two nationally recognized statistical rating organizations ("NRSROs") in the case of commercial paper, or the top four categories in the case of nonconvertible debt and preferred stock, the haircut is reduced from the 15% that would otherwise apply.[3]

The SEC's current proposal is to replace the NSRSO rating standard with a requirement that commercial paper, nonconvertible debt securities or preferred stock would qualify for the lower haircuts if the broker-dealer determines that the investment has only a "minimal amount of credit risk" based on written policies and procedures designed to assess credit and liquidity risks. The SEC proposes that the factors such procedures could consider include:

- Credit spreads, either as spreads to Treasury security yields or as spreads on credit default swaps that reference the security;

- Securities-related research, on the issuer generally or the subject securities specifically;

- Internal or external credit risk assessments, including credit ratings;

[3] The required haircut for qualifying commercial paper is between zero and 0.5% depending on maturity, for qualifying debt is between 2% and 9% depending on maturity, and for qualifying preferred stock is 10%. Securities that do not have a ready market require a 100% haircut regardless of their credit ratings or other characteristics.

- Default statistics showing a probability of default similar to other securities with minimal credit risk;
- Inclusion in an index of instruments that are subject to a minimal amount of credit risk;
- Priorities and credit enhancements such as priority treatment in bankruptcy or overcollateralization;
- Price, yield and/or volume, including whether the price and yield of either the subject security or related credit default swaps are consistent with other securities having minimal credit risk and whether those prices and yields result from active trading; and
- Asset class specific factors, such as the quality of the assets underlying an asset-backed security.

The proposing release notes that the factors considered may vary for different securities, and requests comment on whether to include the list of factors in the rule itself or not. The proposed rule requires broker-dealers to preserve records of their written policies and procedures for examination by the SEC, but does not require recording individual determinations made under the procedures (although the SEC requests comment on this point as well).

The release also notes that comments to the SEC's prior proposals to remove ratings references from the net capital rule expressed concern over decreased transparency of broker-dealers' capital positions, possible decreased market confidence in their financial strength, and increased burden and expense for both broker-dealers and the SEC. The release requests comment on any such unintended effects the current proposal might have (and what alternative formulations that do not rely on credit ratings might have fewer negative effects).

The proposal also would make corresponding revisions to several appendices of Rule 15c3-1:

- Appendix A, which provide for favorable net capital treatment of broker-dealers' proprietary positions in "major market foreign currency" options, which are currently defined by reference to the currency-issuing sovereign's rating and would be defined instead as currencies "for which there is a substantial inter-bank forward currency market."
- Appendix E, which applies varying risk weights (based on the counterparty's ratings by either an NRSRO or the broker-dealer's internal methodology) to market and derivative risks of broker-dealers who use the alternative net capital

computation method and which would, as revised, remove the option of relying on NRSRO ratings instead of internal ratings.

- Appendix F, which permits OTC derivative dealers to use a similar alternative means of compute derivative transaction risk and which would be revised to similarly require those dealers to rely only on their internal credit ratings.

- *Definitions of "Mortgage Related Security" and "Small Business Related Security*." Section 3(a)(41) of the Exchange Act defines the term "mortgage related security," and Section 3(a)(53) defines the term "small business related security." Securities that qualify under these definitions are entitled to favorable treatment under Federal laws that relate to extensions of credit (e.g., Sections 7(g) and 11(d)(1) of the Exchange Act) and that preempt state legal investment and blue sky laws. Currently, the definitions require the applicable securities to be rated in one of the two highest rating categories (in the case of mortgage related securities) or the four highest rating categories (in the case of small business related securities) by at least one NRSRO. However, Dodd-Frank removed those requirements with effect from July 21, 2012, to be replaced with standards of credit-worthiness to be established by the SEC. The SEC seeks comment in the current proposal on what standard to propose. Although the SEC does not formally make the proposal now, the release states that it is considering replacing the current ratings standards with the same "minimal credit risk" standard the SEC proposes for the net capital rule. The release is not clear as to who would be required to make these subjective determinations in these cases and how they would be documented.

- *Broker-Dealer Reserve Requirements and Transaction Confirmations.* The proposal also would:

  - Delete the portion of Exchange Act Rule 15c3-3 that currently permits a broker-dealer to reduce its customer reserve account requirement by margin for customer securities futures on deposit with a clearing organization that has the highest rating from an NRSRO or satisfies alternative qualifications (noting that the only relevant clearing agency also meets the rule's alternative qualifications for this treatment); and

  - Delete the requirement in Exchange Act Rule 10b-10 that requires customer trade confirmations to contain an affirmative statement if a debt security is not rated by an NRSRO (while leaving it in the broker-dealer's discretion to continue to include this statement if they so choose).

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Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Capital Markets in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

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