
Report on Review of Reliance on Credit Ratings

**As Required by Section 939A(c) of the
Dodd-Frank Wall Street Reform
and Consumer Protection Act**



**This is a Report by the Staff of the
U.S. Securities and Exchange Commission**

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This is a report by the Staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

REPORT ON REVIEW OF RELIANCE ON CREDIT RATINGS

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I. Introduction

The staff of the U.S. Securities and Exchange Commission (the “Commission”) has prepared this report pursuant to Section 939A(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”).¹ Section 939A of the Dodd-Frank Act provides as follows:

- (a) AGENCY REVIEW. – Not later than 1 year after the date of the enactment of this subtitle, each Federal agency² shall, to the extent applicable, review –
 - (1) any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument and;
 - (2) any references to or requirements in such regulations regarding credit ratings;
- (b) MODIFICATIONS REQUIRED. – Each such agency shall modify any such regulations identified by the review conducted under subsection (a) to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations. In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each

¹ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

² The Commission is a “Federal agency” for purposes of Section 939A.

such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness; and

- (c) REPORT. – Upon conclusion of the review required under subsection (a), each Federal agency shall transmit a report to Congress containing a description of any modification of any regulation such agency made pursuant to subsection (b).

II. Rule Proposals

The Commission has proposed to amend rules and forms under the federal securities laws in response to the enactment of Section 939A. Below is a description of each proposing release and the proposed amendments. This section describes proposals that do not reflect final action by the Commission on the rules. Comments on the proposals are important in developing the final rules, and the staff is continuing to review comments received on the proposals.

A. Security Ratings Release

On February 9, 2011, the Commission proposed amending certain rules and form requirements under the Securities Act of 1933³ (“Securities Act”) and the Securities Exchange Act of 1934⁴ (“Exchange Act”) that rely on, or make special accommodations for, securities ratings.⁵ The Commission proposed amendments to the following rules and forms:

³ 15 U.S.C. 77a *et seq.*

⁴ 15 U.S.C. 78a *et seq.*

⁵ Security Ratings, Securities Act Release No. 9186 (Feb. 9, 2011) [76 FR 8946 (Feb. 16, 2011)] (“Security Ratings Release”). In proposing the amendments, the Commission took into account comments received on a proposing release from 2008. See Security Ratings, Securities Act Release No. 8940 (July 1, 2008) [73 FR 40106 (July 11, 2008)].

1. Forms S-3⁶ and F-3⁷

Form S-3 and Form F-3 under the Securities Act are the “short forms” used by eligible issuers to register securities offerings under the Securities Act. To be eligible to use Form S-3 or Form F-3, an issuer must meet the form’s eligibility requirements⁸ and at least one of the form’s transaction requirements.⁹ One such transaction requirement permits registrants to register primary offerings of non-convertible securities if they are rated investment grade by at least one nationally recognized statistical rating organization (“NRSRO”).¹⁰ General Instruction I.B.2. in Form S-3 and Form F-3 provides that a security is “investment grade” if, at the time of sale, at least one NRSRO has rated the security in one of its generic rating categories, typically the four highest, which signifies investment grade. The Commission proposed revising General Instruction I.B.2. of Form S-3 and Form F-3 to provide that a primary offering of non-convertible securities is eligible to be registered on Form S-3 and Form F-3 if the issuer has issued at least \$1 billion of non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Securities Act during the past three years (as measured from a date within 60 days of the filing of the registration statement) and satisfies the other relevant requirements of Form S-3 or Form F-3.¹¹ The Commission proposed this criterion because it believed that it was a workable alternative for

⁶ 17 CFR 239.13.

⁷ 17 CFR 239.33.

⁸ See General Instruction I.A. to Forms S-3 and F-3.

⁹ See General Instruction I.B. to Forms S-3 and F-3.

¹⁰ See General Instruction I.B.2. to Forms S-3 and F-3.

¹¹ See Security Ratings Release, supra note 5, at Section II.A.1. Form S-3 also provides that asset-backed securities offerings may be registered using Form S-3 if the securities are “investment grade securities,” based on the ratings of at least one NRSRO. See Section III.A.1. of this report for a discussion of that provision.

determining whether an issuer is widely followed in the marketplace so that Form S-3 and Form F-3 eligibility and access to the shelf offering process would be appropriate.

2. Forms S-4¹² and F-4¹³

Forms S-4 and F-4 under the Securities Act are registration statements under the Securities Act that allow registrants to incorporate by reference certain information if they meet the registrant eligibility requirements of Form S-3 or Form F-3 and are offering investment grade securities.¹⁴ The Commission proposed amending Form S-4 and Form F-4 to permit issuers registering non-convertible debt or preferred securities to be eligible to use incorporation by reference to satisfy certain disclosure requirements of Forms S-4 and F-4 if the issuer has satisfied the proposed eligibility requirements of Forms S-3 and F-3.¹⁵

3. Form F-9¹⁶

The Commission also proposed rescinding Form F-9 under the Securities Act and amending the Securities Act and Exchange Act forms and rules that refer to Form F-9 to eliminate those references. Form F-9 allows certain Canadian issuers to register investment grade debt or investment grade preferred securities that are offered for cash or in connection with an exchange offer, and which are either non-convertible or not convertible for a period of at least one year from the date of issuance. Under the form's requirements, a security is rated "investment grade" if it has been rated investment grade by at least one NRSRO, or at least one Approved Rating Organization, as defined in

¹² 17 CFR 239.25.

¹³ 17 CFR 239.34.

¹⁴ See General Instruction B.1. to Forms S-4 and F-4.

¹⁵ See Security Ratings Release, supra note 5, at Section II.C.1.

¹⁶ 17 CFR 239.39.

National Policy Statement No. 45 of the Canadian Securities Administrators (“CSA”).¹⁷ The Commission proposed rescinding Form F-9 because it no longer believes that keeping Form F-9 as a distinct form would serve a useful purpose. Once amendments to Canadian rules regarding accounting standards become effective,¹⁸ the disclosure requirements for investment grade securities offerings registered on Form F-10 will be the same as the disclosure requirements for those registered on Form F-9, resulting in Form F-9 becoming dispensable.¹⁹

4. Rule 134²⁰

Rule 134(a)(17) under the Securities Act permits the disclosure of security ratings issued or expected to be issued by NRSROs in certain communications deemed not to be a prospectus or free writing prospectus. The Commission proposed removing Rule 134(a)(17) in order to remove the safe harbor for disclosure of credit ratings assigned by NRSROs, because the Commission believed that providing a safe harbor that explicitly permits the presence of a credit rating assigned by an NRSRO is not consistent with the purposes of Section 939A.²¹

¹⁷ See General Instruction I.A. to Form F-9.

¹⁸ See, for example, CSA IFRS-Related Amendments to Securities Rules and Policies (2010), which are available at: http://www.osc.gov.on.ca/documents/en/SecuritiesCategory5/rule_20101001_52-107_ifrs-amd-3339-sup3.pdf.

¹⁹ See Security Ratings Release, *supra* note 5, at Section II.B. The Commission also proposed removing references to Form F-9 in Securities Act Forms F-8 (17 CFR 239.38), F-10 (17 CFR 239.40), F-80 (17 CFR 239.41) and Form F-X (17 CFR 239.42); in Exchange Act Form 40-F (17 CFR 249.240f); and in the following rules: 17 CFR 200.800, 17 CFR 229.10, 17 CFR 230.134, 17 CFR 230.436, 17 CFR 230.467, 17 CFR 230.473, and 17 CFR 232.405. See Security Ratings Release, *supra* note 5, at n. 12.

²⁰ 17 CFR 230.134.

²¹ See Security Ratings Release, *supra* note 5, at Section II.C.3.

5. Rules 138,²² 139²³ and 168²⁴

Rules 138, 139 and 168 under the Securities Act provide that certain communications are deemed not to be an offer for sale or offer to sell a security within the meaning of Sections 2(a)(10)²⁵ and 5(c)²⁶ of the Securities Act when the communications relate to an offering of non-convertible investment grade securities. The Commission proposed revising the rules to be consistent with the proposed revisions to the eligibility requirements in Forms S-3 and F-3.²⁷

6. Schedule 14A²⁸

The Commission also proposed amending Schedule 14A under the Exchange Act. Schedule 14A sets forth requirements for proxy statements and permits a registrant to incorporate by reference if the Form S-3 registrant requirements in General Instruction I.A. are met and action is to be taken as described in certain Items of Schedule 14A that concern non-convertible debt or preferred securities that are “investment grade securities” as defined in General Instruction I.B.2. of Form S-3.²⁹ The Commission proposed amending Schedule 14A to refer to the requirements of General Instruction I.B.2. of Form S-3, rather than to “investment grade securities.”³⁰

²² 17 CFR 230.138.

²³ 17 CFR 230.139.

²⁴ 17 CFR 230.168.

²⁵ 15 U.S.C. 77b(a)10.

²⁶ 15 U.S.C. 77e(c).

²⁷ See Security Ratings Release, *supra* note 5, at Section II.C.2.

²⁸ 17 CFR 240.14a-101.

²⁹ See Note E of Schedule 14A.

³⁰ See Security Ratings Release, *supra* note 5, at Section II.C.1.

B. Investment Company Act Release

On March 3, 2011, the Commission proposed amending certain rules and forms under the Investment Company Act of 1940³¹ (“Investment Company Act”) that contain references to credit ratings.³² The Commission proposed amendments to the following rules and forms under the Investment Company Act.

1. Rule 2a-7³³ and Form N-MFP³⁴

Rule 2a-7 governs the operation of money market funds and it requires these funds to invest only in highly liquid, short-term instruments of the highest quality. To limit these funds to high quality, short-term securities, and to limit the amount of risk a money market fund may assume, Rule 2a-7 sets forth several conditions. Among other conditions, a money market fund can only invest in securities that have received one of the two highest short-term ratings from the “requisite NRSROs” or comparable unrated securities (*i.e.*, “eligible securities”). Under the rule, a “requisite NRSRO” is one of at least four NRSROs that the money market fund’s board of directors has designated (“designated NRSROs”) for use in determining whether a security is an eligible security. In addition, a money market fund’s board of directors (or its delegate) must determine that the security presents minimal credit risks, based on factors related to credit quality, in addition to any rating the security may have received. Rule 2a-7 further requires that at least 97 percent of a money market fund’s portfolio must be invested in “first tier”

³¹ 15 U.S.C. 80a-1 *et seq.*

³² References to Credit Ratings in Certain Investment Company Act Rules and Forms, Securities Act Release No. 9193 (Mar. 3, 2011) [76 FR 12896 (Mar. 9, 2011)] (“Investment Company Act Release”). The Commission also proposed in the Investment Company Act Release a new rule under the Investment Company Act to establish a credit-worthiness standard to replace a statutory reference to credit ratings in the Investment Company Act removed by Section 939(c) of the Dodd-Frank Act.

³³ 17 CFR 270.2a-7.

³⁴ 17 CFR 274.201.

securities (*i.e.*, securities that have received the highest short-term rating from the requisite NRSROs).

The Commission proposed removing references to credit ratings in Rule 2a-7, which would affect five elements of the rule: determination of whether a security is an eligible security; determination of whether a security is a first tier security; credit quality standards for securities with a conditional demand feature; requirements for monitoring securities for ratings downgrades and other credit events; and stress testing.³⁵ The Commission's proposed amendments to Rule 2a-7 are designed to appropriately achieve the same purpose as the ratings requirement.

Under the proposed amendments, a money market fund would continue to be limited to investing in securities that money market fund boards of directors (or their delegates) determine present minimal credit risks, which determination would have to be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations.³⁶ The board (or its delegate) also would have to determine whether each portfolio security is either a "first tier security" or a "second tier security" under the rule. A security would be a first tier security if the fund's board (or its delegate) determines that the issuer (or in the case of a security subject to a guarantee, the guarantor) has the "highest capacity to meet its short-term financial obligations."³⁷ This standard would be similar to the credit quality standards that have been articulated by the credit rating agencies. A security would be a second tier security if it is an eligible security (*i.e.*, a security that the board has determined presents minimal credit risk) but is

³⁵ See Investment Company Act Release, *supra* note 32, at Section II.A.

³⁶ See Proposed Rule 2a-7(a)(11).

³⁷ See Proposed Rule 2a-7(a)(13).

not a first tier security.³⁸ As under the current rule, a money market fund would be required to invest at least 97 percent of its assets in first tier securities. The proposed amendments also would eliminate the requirement that guarantors or guarantees of securities held by money market funds be rated by an NRSRO.³⁹

The Commission also proposed amendments that would remove the credit rating requirement from the Rule 2a-7 provision regarding securities subject to a conditional demand feature.⁴⁰ Rule 2a-7 currently permits a money market fund to invest in a security subject to a conditional demand feature only if, among other things, the underlying security has received a short-term or long-term rating, as the case may be, in one of the two highest categories from the requisite NRSRO, or is a comparable unrated security.⁴¹ Under the proposed amendments, the fund's board (or its delegate) would be required to determine that the security subject to a conditional demand feature be of high quality and subject to very low credit risk.⁴²

The proposed amendments also would amend Rule 2a-7's requirement for monitoring securities for ratings downgrades. Rule 2a-7 currently requires a money market fund's board (or its delegate) promptly to reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks, and take such action as the board determines is in the best interests of the fund and its shareholders.⁴³ The Commission proposed amending the rule to require that, in the event the money market fund's adviser (or any person to whom the board has delegated portfolio

³⁸ See Proposed Rule 2a-7(a)(21).

³⁹ See Rule 2a-7(a)(12)(iii)(A).

⁴⁰ For purposes of Rule 2a-7, a demand feature allows the security holder to receive, upon exercise, the approximate amortized cost of the security, plus accrued interest, if any. A conditional demand feature is a demand feature that a fund may be precluded from exercising because of the occurrence of a condition.

⁴¹ See Rule 2a-7(c)(3)(iv).

⁴² See Proposed Rule 2a-7(c)(3)(iv)(C).

⁴³ See Rule 2a-7(c)(7)(i)(A).

management responsibilities) becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that suggests that the security is no longer a first tier security or a second tier security, as the case may be, the board or its delegate would have to reassess promptly whether the portfolio security continues to present minimal credit risks.⁴⁴

Finally, the proposed amendments would eliminate the references to credit ratings in the rule's stress testing conditions. Rule 2a-7 currently requires money market funds to adopt written procedures for stress testing their portfolios. Specifically, they must test the fund's ability to maintain a stable net asset value per share based on certain hypothetical events, including a downgrade of portfolio securities.⁴⁵ The Commission proposed amending the rule to require that a money market fund's stress testing procedures include as a hypothetical event an adverse change in the ability of a portfolio security issuer to meet its short-term financial obligations.⁴⁶ This hypothetical event is designed to have a similar impact on a money market fund's portfolio as a ratings downgrade.

In addition to amendments to Rule 2a-7, the Commission proposed amendments to Form N-MFP, which is used by money market funds to make monthly electronic filings of portfolio holdings with the Commission.⁴⁷ The form requires money market funds to disclose, among other things, the name of each designated NRSRO for the

⁴⁴ See Proposed Rule 2a-7(c)(7)(i)(A).

⁴⁵ See Rule 2a-7(c)(10)(v)(A).

⁴⁶ See Proposed Rule 2a-7(c)(10)(v)(A).

⁴⁷ See Rule 30b1-7.

portfolio security and the rating assigned to the security. The Commission proposed eliminating from the form the items requiring disclosure of ratings information.⁴⁸

2. Rule 5b-3⁴⁹

Rule 5b-3 under the Investment Company Act permits an investment company, subject to certain conditions, to treat the acquisition of a repurchase agreement as an acquisition of the securities collateralizing the repurchase agreement in determining whether the fund is in compliance with two provisions of the Investment Company Act that may affect a fund's ability to invest in repurchase agreements. One of the conditions of Rule 5b-3 is that the obligation of the seller to repurchase the securities from the fund is "collateralized fully."⁵⁰ A repurchase agreement is collateralized fully if, among other things, the collateral for the repurchase agreement, other than cash or government securities, are securities rated at the time the repurchase agreement is entered into in the highest rating category by the "requisite NRSROs" or unrated securities that are of a comparable quality to securities that are rated in the highest category rating by the requisite NRSROs, as determined by the fund's board of directors or its delegate.⁵¹ In place of this requirement, the Commission proposed to require that collateral other than cash or government securities consists of securities that the fund's board of directors (or its delegate) determines at the time the repurchase agreement is entered into are: (i) issued by an issuer that has the highest capacity to meet its financial obligations; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the

⁴⁸ See Investment Company Act Release, *supra* note 32, at Section II.B.

⁴⁹ 17 CFR 270.5b-3.

⁵⁰ See Rule 5b-3(a).

⁵¹ See Rule 5b-3(c)(1)(iv).

ordinary course of business within seven calendar days.⁵² The Commission designed the proposed amendments to retain a degree of credit quality similar to that under the current rule.

3. Forms N-1A,⁵³ N-2⁵⁴ and N-3⁵⁵

Forms N-1A, N-2 and N-3, among other things, contain the requirements for shareholder reports of open-end management investment companies, closed-end management investment companies, and certain insurance company separate accounts, respectively. The forms currently require shareholder reports to include a table, chart or graph depicting portfolio holdings by reasonably identifiable categories (e.g., type of security, industry sector, geographic region, credit quality or maturity).⁵⁶ If credit quality is used to present portfolio holdings, the forms require that credit quality be depicted using the credit ratings assigned by a single NRSRO. The Commission proposed amending the forms to eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart or graph of portfolio holdings.⁵⁷ If a fund chooses to use NRSRO credit ratings to depict credit quality of portfolio holdings, the proposal, like the current forms, generally would require the fund to use the credit ratings of a single NRSRO. If credit ratings of the NRSRO selected by a fund are not available for certain holdings, the fund must briefly discuss the methodology for determining credit quality for those holdings, including, if applicable, the use of credit ratings assigned by another NRSRO.

⁵² See Proposed Rule 5b-3(c)(1)(iv)(C).

⁵³ 17 CFR 239.15A and 17 CFR 274.11A.

⁵⁴ 17 CFR 239.14 and 17 CFR 274.11a-1.

⁵⁵ 17 CFR 239.17a and 17 CFR 274.11b.

⁵⁶ See Item 27(d)(2) of Form N-1A; Instruction 6(a) to Item 24 of Form N-2; Instruction 6(i) to Item 28(a) of Form N-3.

⁵⁷ See Investment Company Act Release, supra note 32, at Section II.E.

C. Exchange Act Release⁵⁸

On April 27, 2011, the Commission proposed to amend the following rules and one form under the Exchange Act applicable to broker-dealer financial responsibility, distributions of securities, and confirmations of transactions.

1. Rule 15c3-1⁵⁹

Rule 15c3-1, referred to as the “Net Capital Rule,” prescribes minimum net capital requirements for broker-dealers.⁶⁰ In general, the term “net capital” means the net worth of a broker-dealer, computed in accordance with generally accepted accounting principles, adjusted by adding certain subordinated liabilities and subtracting the value of assets not readily convertible into cash and prescribed percentages of the value of securities owned by the broker-dealer (“haircuts”). A primary purpose of the 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 Net Capital Rule currently applies a lower haircut to certain proprietary positions in commercial paper, nonconvertible debt, and preferred stock if the securities are rated in higher rating categories by at least two NRSROs, because those securities typically are more liquid and less volatile in price than securities that are rated in lower rating categories or are unrated.⁶¹ The Commission proposed removing from the Net Capital Rule all references to credit ratings and substituting an alternative standard of credit-worthiness. In place of the current references to credit ratings, the Commission

⁵⁸ Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, Exchange Act Release No. 64352 (April 27, 2011) [76 FR 26550 (May 6, 2011)] (“Exchange Act Release”).

⁵⁹ 17 CFR 240.15c3-1.

⁶⁰ See Rule 15c3-1(a).

⁶¹ See Rule 15c3-1(c)(2)(vi)(E), (F), and (H).

proposed that a broker-dealer take a 15% haircut on its proprietary positions in commercial paper, nonconvertible debt, and preferred stock unless the broker-dealer establishes, maintains and enforces written policies and procedures designed to assess the credit and liquidity risks applicable to a security, and, based on this process, determines that the investment has only a “minimal amount of credit risk.”⁶² If, based on this process, the investment is determined to have only a “minimal amount of credit risk,” the broker-dealer could apply lower haircut percentages. The Exchange Act Release identifies factors that a broker-dealer could consider when determining whether this credit-worthiness standard is met.

2. Appendix A to the Net Capital Rule⁶³

Appendix A to the Net Capital Rule allows broker-dealers to employ a theoretical option pricing model to determine net capital requirements for listed options and related positions. 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 a theoretical option pricing model 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 [NRSROs] and for which there is a substantial inter-bank forward currency market.”⁶⁴ The Commission proposed removing the rating requirement from the definition, so that a “major market foreign currency” would be defined as one in which there is a substantial inter-bank forward currency market.⁶⁵

⁶² See Proposed Rule 15c3-1(c)(2)(vi)(E), (F)(1), (F)(2), and (H).

⁶³ 17 CFR 240.15c3-1a.

⁶⁴ Paragraph (b)(1)(i)(C) of Appendix A.

⁶⁵ See Exchange Act Release, supra note 58, at Section II.A.2.

3. Appendices E and G to the Net Capital Rule⁶⁶

Appendix E to the Net Capital Rule provides that a broker-dealer may apply to the Commission for authorization to use an alternative method for computing capital. Under Appendix E, broker-dealers subject to the alternative method are required to deduct from their net capital credit risk charges that take counterparty risk into consideration. The counterparty risk determination currently is based on either NRSRO ratings or a dealer's internal counterparty credit rating. The Commission proposed removing paragraphs of Appendix E that base credit risk charges for counterparty risk on NRSRO ratings, and in place of these ratings, require a broker-dealer using the alternate computation to apply a credit risk weight of 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.⁶⁷ The Commission also proposed a conforming amendment to Appendix G⁶⁸ to the Net Capital Rule that would delete references to the provisions of Appendix E that the Commission proposed to delete as described above.

4. Appendix F to the Net Capital Rule⁶⁹

Appendix F to the Net Capital Rule sets forth a program for over-the-counter ("OTC") derivatives dealers that allows them to use an alternative approach to computing net capital deductions, subject to certain conditions. 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

⁶⁶ 17 CFR 240.15c3-1e and 17 CFR 240.15c3-1g.

⁶⁷ See Exchange Act Release, *supra* note 58, at Section II.A.3.

⁶⁸ Under Appendix G, a broker-dealer that uses the alternative 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.

⁶⁹ 17 CFR 240.15c3-1f.

counterparty factor of 20%, 50% or 100%, which currently is based on either NRSRO ratings or the firm's internal credit ratings.⁷⁰ The OTC derivatives dealer also must take a concentration charge where the net replacement value in the account of any one counterparty exceeds 25% of the OTC derivative dealer's tentative net capital.⁷¹ The concentration charges also are based on either NRSRO ratings or the firm's internal credit ratings. The Commission proposed amending Appendix F so that an OTC derivatives dealer 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.⁷² The Commission also proposed conforming changes to the General Instructions to Form X-17A-5, Part IIB.⁷³ This form constitutes the basic financial and operational report required of OTC derivatives dealers to be filed with the Commission.

5. Rule 15c3-3⁷⁴

Rule 15c3-3 protects customer funds and securities held by broker-dealers. Among other things, Rule 15c3-3 requires that broker-dealers subject to the rule make a periodic reserve formula computation that takes into consideration how much money the broker-dealer is holding that is either customer money or money obtained from the use of customer securities (credits) and subtracts from that figure the amount of money that the broker-dealer is owed by customers or by other broker-dealers relating to customer transactions (debits). Exhibit A to Rule 15c3-3⁷⁵ contains the formula that a broker-

⁷⁰ See Paragraphs (d)(2) and (4) of Appendix F.

⁷¹ See Paragraph (d)(3) of Appendix F.

⁷² See Exchange Act Release, *supra* note 58, at Section II.A.4.

⁷³ 17 CFR 249.617.

⁷⁴ 17 CFR 240.15c3-3.

⁷⁵ 17 CFR 240.15c3-3a.

dealer must use to determine if it has a reserve requirement, which would be the case if credits exceed debits. 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 registered with the Commission or a derivatives clearing organization registered with the Commodity Futures Trading Commission, provided that the clearing agency or derivatives clearing organization, among other things, maintains the highest investment-grade rating from an NRSRO. The Commission proposed removing the NRSRO rating criterion from the rule.⁷⁶

6. Rules 101 and 102 of Regulation M⁷⁷

Regulation M is designed to 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.⁷⁸

Rules 101(c)(2) and 102(d)(2) currently except “investment grade nonconvertible and asset-backed securities” from these prohibitions. These exceptions apply to nonconvertible debt securities, nonconvertible preferred securities, and asset-backed

⁷⁶ See Exchange Act Release, *supra* note 58, at Section II.B.

⁷⁷ 17 CFR 242.101 and 17 CFR 242.102.

⁷⁸ “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.

securities that are rated by at least one NRSRO in one of its generic rating categories that signifies investment grade. The Commission proposed removing the references to credit ratings in Rules 101(c)(2) and 102(d)(2) and replacing them with new standards relating to the trading characteristics of covered securities. Specifically, the Commission proposed 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 proposal would require a determination to be made using reasonable factors of evaluation and the determination must be subsequently verified by an independent third party.⁷⁹

7. Rule 10b-10⁸⁰

Rule 10b-10 under the Exchange Act generally requires broker-dealers effecting transactions for customers in securities, other than U.S. savings bonds or municipal securities, 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. Paragraph (a)(8) of Rule 10b-10 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. The Commission proposed deleting paragraph (a)(8) from Rule 10b-10.⁸¹ In proposing the amendment, the Commission stated that, “to the extent that the provision is intended to focus investor attention on ratings issued by NRSROs, as

⁷⁹ See Exchange Act Release, *supra* note 58, at Section II.C.

⁸⁰ 17 CFR 240.10b-10.

⁸¹ See Exchange Act Release, *supra* note 58, at Section II.D.

distinct from other items of information, deleting it is consistent with the intent of the Dodd-Frank Act.”⁸²

III. Additional Rules

The discussion above describes rules and forms for which the Commission has already proposed amendments. The staff is continuing to consider how best to address the following rules and form.

A. Asset-Backed Securities: Form S-3 under the Securities Act and Rule 3a-7 under the Investment Company Act

1. Form S-3 under the Securities Act

In April 2010, shortly before enactment of the Dodd-Frank Act, the Commission proposed rules to revise the disclosure, reporting, and offering process for asset-backed securities.⁸³ The proposal included changes to existing requirements under which asset-backed securities offerings may be registered on Form S-3 and offered “off the shelf,” if, in addition to meeting other requirements, the securities are rated “investment grade” by at least one NRSRO.⁸⁴ The proposal would have required the following as conditions to shelf eligibility: risk retention by the sponsor; an undertaking by the issuer to file ongoing Exchange Act reports; a certification filed 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 on the securities as described in the prospectus; and a provision in the pooling and servicing agreement that requires the party obligated to

⁸² Exchange Act Release, supra note 58, at text accompanying note 89.

⁸³ See Asset-Backed Securities, Securities Act Release No. 9117 (April 7, 2010) [75 FR 23328 (May 3, 2010)] (the “2010 ABS Release”).

⁸⁴ In the Security Ratings Release, discussed in Section II.A.1. of this report, the Commission proposed amendments to certain provisions of Form S-3. See Security Ratings Release, supra note 5. The proposed amendments did not address Form S-3 as it applies to asset-backed offerings.

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.

Several months after the 2010 ABS Release, Congress passed the Dodd-Frank Act, which contained new statutory provisions that also addressed asset-backed securities offerings and disclosures. Section 941 of the Dodd-Frank Act adds new Section 15G to the Exchange Act, requiring the Commission and other financial regulators (collectively, the “Agencies”) to jointly prescribe rules regarding mandatory credit risk retention in asset-backed securities offerings. In March 2011, the Agencies proposed rules to implement Section 15G,⁸⁵ and in June 2011 the comment period for that rulemaking was extended until August 2011.⁸⁶ In addition, Section 942(a) of the Dodd-Frank Act amended Section 15(d) of the Exchange Act to eliminate the automatic suspension of the duty to file ongoing Exchange Act reports for asset-backed securities issuers. In January 2011, the Commission proposed rule amendments to reflect this statutory change and permit asset-backed securities issuers to suspend Exchange Act reporting under certain limited circumstances.⁸⁷

Sections 941 and 942 of the Dodd-Frank Act, as well as other provisions of the Dodd-Frank Act relating to asset-backed securities, have changed the regulatory context

⁸⁵ See Credit Risk Retention, Exchange Act Release No. 64148 (Mar. 30, 2011) [76 FR 24090 (Apr. 29, 2011)].

⁸⁶ See Credit Risk Retention, Exchange Act Release No. 64603 (June 6, 2011) [76 FR 34010 (June 10, 2011)].

⁸⁷ See Suspension of the Duty to File Reports for Classes of Asset-Backed Securities Under Section 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 63652 (Jan. 6, 2011) [76 FR 2049 (Jan. 12, 2011)].

for asset-backed securities offerings. Similarly, the Agencies' joint risk retention rulemaking is still ongoing, as described above. In light of these developments, and the comments received on the 2010 ABS Release, the staff is considering how best to proceed on the proposals contained in the 2010 ABS Release, including whether to recommend reproposal of certain aspects of the 2010 ABS release that would include proposed amendments to Form S-3 for offerings of asset-backed securities.

2. Rule 3a-7 under the Investment Company Act

A separate rule bearing on the regulation of asset-backed securities is Rule 3a-7 under the Investment Company Act.⁸⁸ That rule excludes certain issuers of asset-backed securities from the Act's definition of "investment company" subject to certain conditions. One condition is that "securities sold by the issuer or any underwriter thereof are fixed-income securities rated, at the time of initial sale, in one of the four highest categories assigned long-term debt or in an equivalent short-term category...by at least one [NRSRO]...."⁸⁹ In the Investment Company Act Release, the Commission stated that it intended to propose amendments to Rule 3a-7 in a separate release.⁹⁰ One important issue is how best to harmonize Rule 3a-7 with asset-backed securities regulation under the Securities Act and Exchange Act. The staff is considering how best to address Rule 3a-7 in light of the recent developments described above affecting asset-

⁸⁸ 17 CFR 270.3a-7.

⁸⁹ Rule 3a-7(a)(2). The rating requirement in Rule 3a-7 is intended to distinguish structured finance vehicles from investment companies. See Exclusion From the Definition of Investment Company for Structured Financings, Investment Company Act Release No. 19105 (Nov. 19, 1992) [57 FR 56248 (Nov. 27, 1992)]. The Commission stated in that release that "[t]he rating requirement is incorporated in the rule as a means of distinguishing structured financings from registered investment companies. The Commission wishes to emphasize that, although ratings generally reflect evaluations of credit risk, the rating requirement is not intended to address investment risks associated with the credit quality of a financing."

⁹⁰ See Investment Company Act Release, supra note 32 at note 11.

backed issuers, including the passage of the Dodd-Frank Act, and the Commission’s ongoing rulemakings regarding the asset-backed securities markets.

B. Rule 206(3)-3T under the Advisers Act

Rule 206(3)-3T⁹¹ under the Investment Advisers Act of 1940⁹² (“Advisers Act”) is a temporary rule that establishes an alternative means for investment advisers who also are registered with the Commission as broker-dealers to meet the requirements of Section 206(3) of the Advisers Act when they act in a principal capacity in transactions involving, among other things, “investment grade debt securities” with certain of their advisory clients.⁹³ Rule 206(3)-3T(c) defines the term “investment grade debt security” as “a non-convertible debt security that, at the time of sale, is rated in one of the four highest rating categories of at least two [NRSROs].” In 2010, the Commission extended the rule’s sunset date to December 31, 2012, citing the legislative developments in the Dodd-Frank Act as a basis for not otherwise modifying the rule at that time.⁹⁴ Among other things, Section 913 of the Dodd-Frank Act required the Commission to conduct a study, and provide a report to Congress, concerning the obligations of broker-dealers and investment advisers, including the standards of care applicable to those intermediaries and their associated persons. The staff delivered that report in January 2011.⁹⁵ Section 913 also authorizes the Commission to promulgate rules concerning, among other things, the legal or regulatory standards of care for broker-dealers, investment advisers, and their associated

⁹¹ 17 CFR 275.206(3)-3T.

⁹² 15 U.S.C. 80b-1 *et seq.*

⁹³ Section 206(3) of the Advisers Act makes it unlawful for any investment adviser, directly or indirectly, “acting as a principal for his own account, knowingly to sell any security to or to purchase any security from a client . . ., without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.”

⁹⁴ See Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Advisers Act Release No. 3128 (Dec. 28, 2010) [75 FR 82236 (Dec. 30, 2010)] (“Principal Trades Release”).

⁹⁵ See Study on Investment Advisers and Broker-Dealers (Jan. 21, 2011), available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

persons for providing personalized investment advice about securities to retail customers. In the release extending the sunset date of Rule 206(3)-3T, the Commission stated that, “[a]s part of our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers, we intend to carefully consider principal trading by advisers, including whether Rule 206(3)-3T should be substantively modified, supplanted, or permitted to expire.”⁹⁶ The staff, in preparing any recommendation to the Commission regarding whether Rule 206(3)-3T should be amended, replaced, or allowed to lapse, will address the requirements of Section 939A.

IV. Conclusion

The Commission has proposed amendments to several rules and regulations in response to Section 939A and is continuing to review comment letters received and consider how best to address a number of other rules and forms.

⁹⁶Principal Trades Release, supra note 94, at text accompanying note 12.